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Recovery of Indirect Costs in the Pricing of Equitable
Adjustments and Terminations for Convenience

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PREFACE

The author is a United States Air Force judge advocate, currently assigned to the Air Force Contract Law Center, at Wright-Patterson Air Force Base, Ohio.

The views expressed herein are solely those of the author and do not purport to reflect the position of the Department of Defense, or any other agency of the United States Government.

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INTRODUCTION

Equitable adjustments and terminations for convenience are noncompetitive pricing actions--cost rather than market forces determines whether price is fair and reasonable.

Determining indirect costs for purposes of pricing an equitable adjustment or termination for convenience presents a number of problems for the contracting community. First, lawyers, judges, and contracting officers often do not understand how contractors accumulate and assign indirect costs to the work performed during an accounting period. They do not understand what an indirect cost rate is or how it functions and for this reason are ill equipped to deal with the more complex issues of consistency and unabsorbed overhead.

Second, all costs do not respond to changes in production volume in the same way. For example, fixed costs do not increase or decrease with production volume within a relevant range of production. Therefore, the effect that a change order or termination for convenience has on the amount of indirect cost depends upon the types of indirect costs involved and their response to change. While the amount of fixed indirect cost does not increase or decrease in response to changing volume, the proportionate share of fixed indirect

cost borne by each unit of production increases as volume falls and decreases as volume rises.

→ 3)
~~Third~~, most contractors have unsophisticated cost accounting systems that cannot measure performance costs accurately at various stages of contract completion or the increase in costs caused by an event necessitating an equitable adjustment. This is because contractors do not need sophisticated cost accounting systems for financial reporting or normal decision making purposes.

→ 4)
~~Fourth~~, consistent classification of costs as direct or indirect is necessary to prevent over recovery. Contractors have considerable incentive to classify the costs of an equitable adjustment or termination settlement as direct costs. Not only are direct costs recovered in their entirety but a percentage markup for indirect costs is added thereto. In contrast, indirect costs go into an indirect cost grouping, where at best they serve to increase the percentage markup on direct costs. Serious overcharging results when indirect costs are improperly classified as direct.

→ 5)
~~Fifth~~, when contracts are terminated for convenience direct recovery of certain normally indirect costs is permitted. Although direct charging may be necessary to equitably compensate the contractor for its efforts, direct charging creates opportunities for over recovery of costs--

particularly when a markup for indirect costs is also permitted.

→ Unfortunately, the procurement regulations and accounting and legal literature give little guidance on how to determine indirect costs for purposes of equitable adjustments and terminations for convenience. The purpose of this thesis is, in part, to fill that gap. Chapter one presents fundamental principles; it examines (1) the purpose of equitable adjustments and termination settlements, (2) the relationship between cost and price, (3) classification of costs as direct or indirect, (4) the basic elements of an indirect cost rate, (5) the effect of fluctuations in volume on cost, (6) the difference between full costing and direct and absorption costing, and (7) allowability of costs under the Cost Principles.

Key words: the volume product costing, overhead, cost accounting, (etc)

Chapter 2 explains how indirect cost rates are used to price equitable adjustments. Projected, actual, negotiated, and standard indirect cost rates are discussed. Of particular importance is the discussion of how changes in production volume affect projected indirect cost rates. Finally, Chapter 2 suggests that equitable adjustments infrequently return contractors to the position they would have been in "but for" the event necessitating the equitable adjustment. This is because equitable adjustments include recovery of fixed indirect costs although the event necessitating the

equitable adjustment does not cause the contractor to incur more or less fixed indirect cost.

Chapter 3 analyzes unabsorbed and extended overhead. Extended overhead is shown to be distinct from unabsorbed overhead and probably unrecoverable. Generally, the boards of contract appeals and the courts have used the *Eichleay* formula to measure unabsorbed overhead. The author finds the *Eichleay* formula to be an accurate measure of unabsorbed overhead in very limited circumstances and identifies six presumptions upon which the formula's validity rests. Unabsorbed overhead need not be measured by a formula; the amount of unabsorbed overhead can be estimated accurately. Furthermore, the boards of contract appeals are not bound by precedent to use the *Eichleay* formula where it does not apply or a more useful method of measuring unabsorbed overhead is available.

Chapter 4 studies recovery of indirect costs upon termination for convenience. Termination settlements involve three broad categories of costs: pre-termination, continuing, and settlement costs. Additionally, when a contract is partially terminated for convenience, contractors are allowed an equitable adjustment for any resulting increase in the costs of performing the unterminated portion of the contract. For purposes of a termination settlement many normally indirect costs are recovered directly. Chapter 4 explores whether

direct recovery is a consistent accounting practice and determines what adjustments, if any, are necessary to prevent over recovery of cost. Frequently unabsorbed overhead is recoverable when a contract is terminated for convenience. Chapter 4 analyzes recovery of pre-termination and post-termination unabsorbed overhead as well as unabsorbed overhead for partially terminated contracts.

Chapter 5 discusses consistency as it applies to recovery of indirect costs. This chapter examines the purpose and source of the consistency requirement and how it relates to classification of costs as direct or indirect, assignment of costs to indirect cost groupings, distribution of indirect cost groupings, and base period selection. Particularly noteworthy is the illustration of over recovery resulting from inconsistent classification of costs as direct or indirect. Despite the consistency requirement, contractors are permitted if not required to change their cost accounting practices when such practices become inequitable as a result of changing circumstances. Chapter 5 explains when cost accounting practices can be changed without running afoul of the consistency requirement and whether the change can be applied retroactively. Chapter 5 closes by examining the consistency requirement as it specifically applies to equitable adjustments and termination settlements.

It is hoped that this thesis will help the contracting community better understand recovery of indirect costs in the pricing of equitable adjustments and terminations for convenience.

CHAPTER 1
UNDERSTANDING THE FUNDAMENTAL PRINCIPLES

I. EQUITABLE ADJUSTMENTS

A. Purposes Served by Equitable Adjustments

One significant difference between contracting with the Government and contracting with most commercial organizations is the Government's insistence on the contractual right unilaterally to order "changes" in work during contract performance.¹ In return for this right, the Government promises to make an "equitable adjustment" to the contract price whenever a change is ordered that either increases or decreases the contractor's costs of performance. The Changes clause² allows the Government flexibility in return for the promise of an equitable adjustment should the Government exercise that flexibility. It permits the Government to respond to changing circumstances and take advantage of technological advances.

In addition, an equitable adjustment is used, by contractual agreement, as the remedy in situations where the Government otherwise would be in breach of contract. For example, an equitable adjustment is the contractually required remedy when government furnished property is late or defective.³ Similarly, where the Government unreasonably delays

performance of a construction contract, the contractor is entitled to an adjustment for any increased costs of performance rather than damages for breach of contract.⁴

An equitable adjustment is also a vehicle to allow the Government to assume certain risks which at common law were assumed by the selling party. For example, construction contracts include a Differing Site Conditions clause that permits an equitable adjustment if the contractor encounters subsurface or latent defects of an unknown and unusual nature.⁵ Thus, a contractor can bid on a contract without making an extensive site examination or including a contingency in its bid to protect itself against potential unfavorable conditions.⁶

Equitable adjustments have other uses as well. The above discussion merely discloses the more important uses and provides an indication of the role adjustments play in Government contracting.

B. Defining an Equitable Adjustment

Although provisions for "equitable adjustments" are contained in numerous contract clauses, the procurement regulations neither define equitable adjustments nor explain how they should be computed. This has been left to courts and the boards of contract appeals.⁷ In general, "[t]he term

'equitable adjustment' refers to a legal concept of returning the parties in a contract to the same relative positions they occupied before implementing the change, preserving to each as nearly as possible the advantages and disadvantages of their bargain."⁸

The Court of Claims defines equitable adjustments as "simply corrective measures utilized to keep a contractor whole when the Government modifies a contract."⁹ "[T]he purpose of an equitable adjustment under the Changes clause is 'to compensate the contractor for the unanticipated and extra out-of-pocket expense it incurred in performing the contract as a result of the changes.'"¹⁰ For this reason, damages are measured by the contractor's increased costs of performance rather than by the increase in value, if any, received by the Government.¹¹

Another important concept is the idea that an equitable adjustment should not change the contractor's "profit or loss" on the unchanged portion of the contract.¹² Repricing should be limited to the effect of the change alone and should not alter the basic profit or loss position of the contractor on the unchanged work.¹³

The formula for pricing an equitable adjustment is based upon "the difference between what it reasonably would have cost to perform the work as originally required and what it

reasonably cost to perform the work as changed."¹⁴ Restated, the amount of an equitable adjustment is determined by the amount of "increase or decrease" in a contractor's costs of performance.¹⁵ Once this cost difference is ascertained, a fair and reasonable amount of profit is calculated for the change. The cost difference plus profit equals the amount of an equitable adjustment.

Under certain contract clauses, a contractor is entitled to an "adjustment" rather than an "equitable adjustment."¹⁶ The difference between the terms is simply that an equitable adjustment includes profit on the increased costs of performance, while an adjustment does not include any amount for profit. Because this is the only difference between the two terms, for convenience, I will use the terms interchangeably during the course of this paper.

II. TERMINATIONS FOR THE CONVENIENCE OF THE GOVERNMENT

Another important right the Government usually obtains by contractual provision is the right to terminate the contract (in whole or in part) for its convenience. The Termination for Convenience clause¹⁷ "gives the Government the broad right to terminate without cause and limits the contractor's recovery to costs incurred, profit on work done and the costs

of preparing the termination settlement proposal."¹⁸ What a contractor does not get is anticipatory profit.

"A [termination] settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit."¹⁹ The goal is to compensate the contractor for its reasonable costs in performance of the contract including those costs that cannot be discontinued immediately upon termination,²⁰ and for costs caused by the termination--such as settlement costs.²¹ The contractor's costs determine the amount of a termination settlement. Computation of "cost" for a termination settlement is more complex than for an equitable adjustment, in that more costs are involved (costs of work performed before termination, continuing costs, and settlement expenses). In addition, if the termination is only partial, the costs of the unterminated portion of the contract may need to be reassessed.²²

III. COST--ITS RELATIONSHIP TO PRICE

Cost of performance is the dominant factor in pricing both adjustments and termination settlements. Performance costs are not nearly so important in other pricing situations. For example, in a "competitive" market, performance cost does not

determine price.²³ Price is determined by competition and opportunity cost.

Pricing of adjustments and termination settlements takes place in a noncompetitive environment. Any "[r]eal or potential competition existing before . . . award [of a contract] disappears when the contract is signed. The competing offeror becomes a sole source contractor."²⁴ With competition no longer present as a restraint on price, the contractor's reasonable costs of performance are used as the measure of an adjustment or termination settlement.

IV. DEFINING, MEASURING, AND ALLOCATING COSTS

Because cost is the focus of an equitable adjustment or termination settlement, it is important to ascertain just what cost is and how the cost of an item is determined.

A. Defining Cost²⁵

Surprisingly, the procurement regulations do not attempt to define the word "cost" although the FAR devotes an entire part to cost.²⁶ Similarly the four major texts²⁷ on Government accounting do not define the word "cost." The probable reason for this omission is the difficulty in devising one definition to fit the many ways in which the word "cost" is used. In lieu of defining "cost," the

procurement regulations and the Government accounting texts define various types of cost.

B. Cost Accounting Standards (CAS)²⁸

The cost data upon which cost reimbursement and price negotiation are based depend upon information developed from a contractor's cost accounting system. For this reason, the Government takes great interest in the quality of a contractor's cost accounting system and cost accounting practices. The purpose of the CASB and the standards it promulgated was to improve the quality of cost data available for negotiation and cost reimbursement purposes.

The CAS are included in the FAR at Subpart 30.3. They apply only to certain high dollar value contracts.²⁹ When applicable, the CAS impose accounting controls upon Government contractors. The CAS prescribe methods to (1) measure (2) assign, and (3) allocate cost. In addition, for certain large-volume Government contractors, the CAS require extensive cost accounting disclosure.³⁰ The CAS are mandatory only when the subject contract is CAS-covered³¹ or when a CAS is incorporated by the Cost Principles.³²

For recovery of indirect costs, the most important of the CAS are:

- a. CAS 401, Consistency in Estimating, Accumulating, and Reporting Costs;
- b. CAS 402, Consistency in Allocating Costs Incurred for the Same Purpose;
- c. CAS 403, Allocation of Home Office Expenses to Segments;
- d. CAS 406, Cost Accounting Period;
- e. CAS 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives;
- f. CAS 418, Allocation of Direct and Indirect Costs.

The CAS listed above are general standards. The CAS also prescribe detailed accounting rules for specific indirect costs, such as personal absence compensation,³³ depreciation,³⁴ material acquisition costs,³⁵ pension costs,³⁶ cost of facilities capital,³⁷ deferred compensation,³⁸ insurance costs,³⁹ independent research and development costs (IR&D),⁴⁰ and bid and proposal costs (B&P).⁴¹

C. The Cost Principles

The Cost Principles⁴² prescribe rules for determining cost. They govern many aspects of cost including measurement, allocability, and reasonableness. Unlike the CAS, the Cost Principles apply to all Government contracts. The FAR requires the contracting officer to incorporate the Cost Principles, by reference, in all commercial contracts as the basis for, among other things, proposing, negotiating, or

determining costs under terminated contracts;⁴³ and for pricing changes and other contract modifications.⁴⁴

D. Measurement of Cost

"In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used, including standard costs properly adjusted for applicable variances."⁴⁵ Surprising as it might seem, there is no one correct way of determining or measuring cost. Inventory can be valued by a number of methods including the last in first out (LIFO), first in first out (FIFO), or moving average method. Purchases of raw materials, labor, and overhead can be charged to a project using either standard or actual costing. Alternative methods exist for calculating depreciation and a variety of methods can be properly used to allocate costs to cost objectives.

As indicated above, the method chosen to determine and measure costs must be generally accepted, equitable, and consistently applied.⁴⁶ Reasonable minds can differ in each of these areas--there are few clear lines. Judgment plays an important role. It is therefore not surprising that what constitutes cost and how cost is measured has been the subject of frequent litigation.

E. Accounting Systems

Accounting systems designed for financial reporting purposes usually do not provide the information necessary to make individual pricing decisions.⁴⁷ Accounting for financial reporting purposes is concerned with the information needs of investors, creditors, and government agencies and focuses on presenting the overall financial condition of the firm--it does not measure the additional costs of performance caused by a change.

To determine the cost of a change, a contractor's accounting system must identify, measure, accumulate, and distribute costs to the change. A cost accounting system is needed to provide management with this information.

Ordinarily, cost accounting systems are designed to record the costing of "normal recurring activities."⁴⁸ "Changes tend to involve 'abnormal' situations. Thus, most cost accounting systems do not readily identify and measure the cost of changes."⁴⁹ For this reason, professors Bedingfield and Rosen recommend that contractors be prepared to perform special analyses to identify and measure the cost impact of changes and other events necessitating equitable adjustments.⁵⁰ Finally, cost accounting systems "produce[] approximations, not precise statements of the true cost.

Because many estimates and allocations are involved in every cost system, 'true' costs exist only in theory."⁵¹

F. Allocation of Costs

A significant number and variety of costs must be incurred in order to perform a contract successfully. The process of assigning costs to cost objectives⁵² is called "allocation."⁵³ Under the FAR, a cost is allocable to a Government contract if it "(a) is incurred specifically for the contract; (b) benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or (c) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown."⁵⁴

1. Direct Costs

"Total cost" for purposes of an equitable adjustment or termination settlement is the sum of the allowable direct and indirect costs allocable to the adjustment or termination settlement.⁵⁵ A "direct cost" is commonly defined as a cost incurred for the exclusive benefit of a single cost objective.⁵⁶ Under the FAR, "[a] direct cost is any cost that can be identified specifically with a particular final cost objective."⁵⁷ Direct costs are charged directly to the cost objective benefited.⁵⁸ In a

manufacturing company direct costs usually refer to costs easily identified with the product.⁵⁹ "Generally, this includes direct materials (raw materials) and direct labor."⁶⁰

2. Indirect Costs

"Indirect costs" are those costs incurred for the benefit of two or more cost objectives.⁶¹ "After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to the several cost objectives."⁶² Indirect costs are not charged directly to cost objectives, but are accumulated in logical cost groupings and then allocated to benefited cost objectives in proportion to the benefits received.⁶³ In a manufacturing company, indirect costs include "factory utilities, salary of the plant manager, depreciation on the factory building, and factory telephone costs."⁶⁴

3. Classification of Costs as Direct or Indirect

"The Cost Principles express a preference for direct charging--requiring that all costs which can be identified specifically with a particular cost objective be charged directly to that cost objective."⁶⁵ Costs which can be specifically identified with other final cost objectives are direct costs of those cost objectives and are not includable

in indirect cost groupings.⁶⁶ This preference for direct costing has, as a general rule, been followed by the boards of contract appeals in pricing equitable adjustments and contract termination settlements.⁶⁷

However, before a cost can be charged directly, "[it] must not only meet the criteria established for direct costs, but must also be segregated from other costs and recorded in accounts identifying the costs with the contract or other cost objective."⁶⁸ An accounting system capable of accurately segregating costs for direct charging is expensive to develop and maintain, and is often impractical.⁶⁹ For this reason, both the Cost Principles and CAS 402 permit direct costs of a minor dollar amount to be treated as indirect costs, if the accounting treatment is applied consistently and produces substantially the same results as direct treatment.⁷⁰

The "nature" of a cost (material, labor, supplies, etc.) does not determine whether it will be classified as direct or indirect.⁷¹ "The critical factor is the essential relationship between the cost and the benefit conferred, regardless of the nature of the goods or service used. Where only one cost objective benefits from the goods or services consumed, it alone should bear the expense."⁷² Thus, a cost may be direct in one set of circumstances and indirect in another. For example, telephone costs are usually treated as

an indirect cost. However, when telephone costs are material in amount, a contractor may monitor and charge telephone calls directly to specific cost objectives while treating the equipment, advertisement, and tax portion of the expense as an indirect expense.⁷³

4. Process of Allocating Indirect Costs to Cost Objectives

Allocation of indirect costs requires selection of (1) logical cost groupings or pools for accumulating indirect costs, (2) a distribution base for allocating indirect costs to the several cost objectives, and (3) a base period over which indirect costs can be accumulated.

a. Indirect Cost Groupings

(i) Cost Principles. The FAR provides the following guidelines for grouping indirect costs:

Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative (G&A) expenses are separately grouped. Similarly, the particular case may require subdivisions of these groupings, e.g., building occupancy costs might be separable from those of personnel administration within the manufacturing overhead group. This necessitates selecting a distribution base common to all cost objectives to

which the grouping is to be allocated. The base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives.⁷⁴ When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.⁷⁵

Since costs are incurred for different reasons, the larger the number of cost groupings, the more precisely indirect costs can be assigned to cost objectives.⁷⁶ "Notwithstanding the accuracy obtained from multiple pools, the expense and inconvenience involved in maintaining an accounting system sufficient to handle the establishment of many pools is a critical factor in determining how many indirect pools will be maintained."⁷⁷ "[T]he general practice is to use few pools and few bases."⁷⁸

In contrast to general practice in the private sector, the FAR requires a cost accounting system capable of allocating indirect costs with considerable precision.⁷⁹ Such a system is appropriate for a contractor performing work on a cost reimbursement basis, where precision is required and where the Government routinely reimburses the contractor, at least in part, for the costs of maintaining such a system. But a contractor with a fixed priced contract cannot realistically be expected to maintain a complex cost accounting system, solely for the purpose of supporting a "possible" equitable adjustment or termination settlement.⁸⁰

(ii) Common Indirect Cost Groupings. The FAR lists "manufacturing overhead, selling expenses, and general and administrative (G&A) expenses" as examples of costs that are often grouped separately.⁸¹ Other categories of cost that are often grouped separately include material overhead, engineering overhead, field service, job site, use and occupancy, quality control, fringe benefits, and home office.⁸²

The term "overhead" has several meanings. It is used as (1) a synonym for indirect cost,⁸³ and (2) the name of a specific type of indirect cost grouping--support costs associated with general product lines, organizational groups, and groups of contracts.⁸⁴ The indirect cost grouping "overhead" should be distinguished from G&A costs (a separate indirect cost grouping), which represents accumulation of indirect costs on a much broader level. G&A costs provide support to the business unit as a whole and do not relate to any particular product or service.⁸⁵ The CAS distinguish between overhead and G&A and require that contractors use different allocation procedures.⁸⁶ The CAS recognize a third indirect cost grouping--home office expense.⁸⁷ Again, separate allocation procedures are prescribed.⁸⁸

b. Distribution Base

The allocation process requires that indirect costs be accumulated in logical cost groupings and then distributed to the several cost objectives. An element that closely relates to the benefits received from an indirect cost grouping and is common to the several cost objectives is selected as the "distribution base." The indirect cost grouping is divided (allocated) among the several cost objectives in proportion to the amount of the distribution base that each cost objective has generated. Horngren defines a distribution base as a systematic means of linking a given cost pool with cost objectives.⁸⁹

Selection of a proper distribution base is important, because it determines how an indirect cost grouping will be distributed among the several cost objectives. Under the FAR, the base selected should "permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives."⁹⁰ Not everyone agrees. Rishe, for example, states that "[t]he most proper base is that which will allocate accumulated costs to contracts in approximately the same proportion as each contract generated the costs."⁹¹ A cost may be "generated" or "caused" by a cost objective and yet not be consumed by that cost objective. Thus, the cost may benefit other cost objectives as well. The FAR's approach is that each cost objective benefiting from the cost

should be allocated a share of the cost in proportion to the benefits received, whether or not the cost was generated or caused by the benefiting cost objective.⁹²

When relative benefit is not ascertainable, the FAR will permit allocation on another "equitable basis."⁹³ However, allocation based on relative benefit is the preferred approach.⁹⁴

Bases commonly used to distribute indirect costs include: direct labor hours, machine hours, direct labor cost, direct material cost, number of employees, square footage, and kilowatt hours.⁹⁵ The CAS, when applicable, provide specific guidelines for selecting a distribution base.⁹⁶ A "cost of sales" base although commonly used by commercial enterprises generally is unacceptable for Government contracting purposes.⁹⁷

c. Base Period

The period during which indirect costs are incurred and accumulated for distribution to work performed in that period is called the "base period."⁹⁸ The "length" of the base period is important because of its ability to affect the indirect cost rate and ultimately the amount of indirect cost allocated to a cost objective.

A short cost period might be subject to seasonal variations, and thus yield cost allocation rates which do not accurately reflect the normal operations of the contractor's business. Cost recovery would then vary greatly, although the contractor's operations might have remained at a constant level. On the other hand, long cost periods could attenuate the relationship between the indirect costs and the direct costs which generated them, especially when a significant change in the contractor's operations occurs.⁹⁹

CAS 406 provides the criteria and guidance for base periods of contracts subject to "full CAS coverage."¹⁰⁰ CAS 406 requires use of a year long base period.¹⁰¹ For non-CAS-covered and modified CAS-covered¹⁰² contracts, a base period shorter than one year may be permitted when performance involves only a minor portion of the fiscal year or when it is general practice in the industry to use a shorter period.¹⁰³ Adjustments may be necessary when a period shorter than one year is used in order to match indirect costs incurred during that period with the benefits they generated.¹⁰⁴ While the FAR is silent on whether periods longer than one year may be used, their use may distort the relationship between costs and the operations which generated such costs.¹⁰⁵ Further, the base period cannot include years in which no contract costs were incurred--even if production volume varies significantly by year and inclusion would better approximate the contractor's average indirect cost rate.¹⁰⁶

d. Indirect Cost Rates

Indirect costs are usually allocated to cost objectives by use of an indirect cost rate. An indirect cost rate is "the percentage or dollar factor that expresses the ratio of indirect expense incurred in a given period to direct labor cost, manufacturing cost, or another appropriate base for the same period."¹⁰⁷ To illustrate how an indirect cost rate would determine indirect costs for purposes of a change order, assume a contractor in FY 1988 (base period) had material overhead of \$1 million (indirect cost grouping) and direct material of \$25 million (distribution base). The material overhead rate is calculated by dividing the \$1 million material overhead cost grouping by the \$25 million of direct material to obtain a 4% material overhead rate. This material overhead rate, when multiplied by the increased direct material costs caused by a change, will equal the material handling costs allocable to the change. Assume the change increased direct material costs by \$15,000. The material handling costs of the change would be 4% of \$15,000, or \$600.

V. HOW VOLUME AFFECTS COSTS

Change orders and terminations for convenience normally either increase or decrease the amount of work to be performed by a contractor. In order to determine their "cost

impact" on a contractor, the relationship between volume and cost must be understood.

A. Classification of Costs as Fixed or Variable

Costs vary in their response to changes in volume--some costs will not increase at all and others will increase significantly in the face of even minor volume changes. Understanding which costs respond to fluctuations in volume and measuring that response is critical to accurately assessing the increase or decrease in costs caused by a change.

The *Accountant's Cost Handbook* categorizes costs as variable, fixed, semifixed, or semivariable depending upon their response to changes in volume.¹⁰⁸ Each category is discussed below.

(1) Variable Costs. "Variable costs change proportionately with changes in volume and would be zero at zero volume. . .

. In a manufacturing operation, variable costs normally include materials, direct labor, and some overhead costs."¹⁰⁹

(2) Fixed Costs. "Fixed costs do not vary with volume."¹¹⁰

Costs are fixed only in the short run; over time all costs are variable. In practice, costs are considered fixed if they do not vary over the "relevant range" of production.¹¹¹

"The relevant range is that level of activity for which the firm budgets and expects to operate."¹¹² Examples of fixed

costs include rent, depreciation, property insurance, and property taxes.¹¹³

(3) Semifixed Costs. Semifixed costs are also known as step fixed costs. "[They] are fixed over some range of output and then increase (or decrease) by a given amount at certain critical points."¹¹⁴ An example of a semifixed cost is the salaries of foremen, each of whom can supervise the manufacture of 5 units of production, but no more.

(4) Semivariable Costs.¹¹⁵ Semivariable costs have elements of both fixed and variable costs. The fixed component usually reflects a minimum charge necessary to make service available.¹¹⁶ Examples include electricity and telephone costs.

The concept of fixed and variable costs is critical not only for pricing, but also for planning, decision making, and evaluating and controlling management performance.¹¹⁷ In practice, it is not always easy to determine which costs, or portions of costs, are fixed and which are variable. Techniques used to separate fixed from variable costs include subjective estimates by managers, graphic correlation, the accounting method, the standby cost method, the high-low method, simple linear regression, and multiple linear regression.¹¹⁸

B. Contribution Margin and Breakeven Point

Contribution margin is an important concept in pricing a product. A contractor cannot remain in business long unless its prices allow recovery of both its fixed and variable costs. Contribution margin and breakeven point are used in determining the price and sales volume necessary to allow recovery of fixed costs. "Contribution margin" is the amount by which sales price exceeds all variable expenses--the amount of the selling price available for recovery of fixed costs.¹¹⁹ The "breakeven point" is the number of units that must be sold at a given price to permit recovery of fixed costs.¹²⁰ To illustrate, assume fixed costs of \$10,000, variable costs of \$1500, and a unit selling price of \$2500. The contribution margin would be \$1000 (\$2500 selling price less \$1500 variable costs) and the breakeven point 10 units (\$10,000 fixed costs/\$1000 contribution margin).

VI. Methods of Product Costing

The cost of a product is generally determined by using one of three accounting methods: absorption costing, full costing, or direct costing. What distinguishes the three costing methods is their treatment of "fixed" costs as either a cost of the product or a "period expense."¹²¹ Fixed costs are often substantial and the "cost" of a product can vary significantly depending upon the costing method selected.

A. Absorption Costing

1. In General

The term "absorption costing" refers to the process of allocating costs to **products** as opposed to charging costs off as **period expenses** in the year incurred. Two forms of absorption costing should be distinguished: (1) absorption costing required for financial reporting purposes and (2) absorption costing used for pricing equitable adjustments and termination settlements. The two differ markedly.

Failure of the accounting profession to give different names to the two forms of absorption costing is a source of confusion. The term "absorption costing" is most commonly associated with the product costing method required for financial reporting purposes.¹²² For this reason, I will use the term "absorption costing" to mean the product costing method required for financial reporting purposes. I will use the term "full costing" will mean the product costing method used to determine cost for pricing equitable adjustments and termination settlements.¹²³

2. Absorption Costing For Financial Reporting Purposes

Generally Accepted Accounting Principles (GAAP) require that "absorption costing" be used for financial reporting purposes.¹²⁴

Absorption costing requires the allocation of all **manufacturing costs**, direct or indirect, fixed or variable, to products. . . . Specifically no distinction is made in allocating indirect costs between the amount which is fixed and the amount which is variable. Both are fully allocated to or 'absorbed' by the final cost objectives--the products.¹²⁵

Non-manufacturing expenses such as selling and G&A are not allocated to products, but are expensed as "period costs."

Absorption costing is not a particularly useful tool for either decision making or pricing.¹²⁶ For decision making, the relevant costs are variable costs; for pricing, the relevant costs are opportunity costs.¹²⁷ Absorption costing is a better indicator of cost for retroactive pricing (pricing which takes place after the work is complete) than for prospective pricing, but even here it is not particularly useful because it treats costs other than manufacturing costs as period costs unrelated to the product.

B. Full costing

"Full costing" is the product costing method used to determine cost for pricing Government change orders and termination settlements. Under full costing every cost is identified with a particular contract.¹²⁸ All of a contractor's costs, whether direct or indirect, fixed or variable, including costs normally treated as period costs are allocated to final cost objectives; that is, they are fully absorbed.¹²⁹ Full costing differs from the costing required for financial reporting purposes in that all costs--not just manufacturing costs--are allocated to products.¹³⁰ Because of the need to allocate all of the contractor's costs, "full costing requires . . . a more sophisticated accounting system than the average contractor would need for purely commercial operations."¹³¹

C. Direct Costing

"Direct costing differs from absorption costing in that under direct costing only variable manufacturing costs are allocated to a product. Fixed manufacturing expenses are charged as period--not product--costs."¹³²

The primary objective of direct costing is control. By eliminating . . . expenses over which local management has little or no control, direct costing focuses attention on the items that local management is responsible for controlling. Variable expenses are controllable; fixed expenses--at least in the short

run--are not. Direct costing is built on this distinction.¹³³

If direct costing were used to price adjustments, recovery would be limited to the incremental manufacturing expenses caused by the change. The contractor would recover only variable manufacturing costs and would not recover any fixed costs.

VII. ALLOWABILITY UNDER THE COST PRINCIPLES

Under the Cost Principles, a contractor can include only "allowable" costs in any billing, claim or proposal.¹³⁴ Thus, the "total cost" of a change order or a terminated contract, for pricing purposes, is the sum of its allowable direct and indirect costs.¹³⁵ If a cost is "unallowable," a contractor will not recover that cost even if it is otherwise properly allocable to the modification or termination settlement. Several factors determine whether a cost is allowable:¹³⁶

- (1) Reasonableness;
- (2) Allocability;
- (3) Standards promulgated by the CASB, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances;
- (4) Terms of the contract;
- (5) Any limitations set forth in FAR Subpart 31.

The CAS and allocability have already been discussed.¹³⁷ The remaining factors are discussed below.

A. Reasonableness

A cost is generally not recoverable if its incurrence is deemed unreasonable. Under the Cost Principles, "[a] cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."¹³⁸ "What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question."¹³⁹

1. Burden of Proof

Recent changes to the Cost Principles, eliminate the presumption that costs actually incurred by a contractor are reasonable and place the burden of proving reasonableness on the contractor.¹⁴⁰ The previous rule, established in 1963 by the Court of Claims, created a presumption that costs actually incurred were reasonable and placed the burden of proving unreasonableness upon the Government.¹⁴¹ The previous rule still applies to contracts executed before the effective date of the change, unless the parties mutually agree otherwise.¹⁴²

2. Determining Reasonableness of Indirect Costs

"The proper way to apply the standard of reasonableness to . . . overhead costs is to examine them on an item by item basis and exclude from the allowable overhead pools the specific overhead cost items or parts of items found to be unreasonable under the prevailing circumstances."¹⁴³ The focus is on the reasonableness of the individual elements making up the overhead cost pool, not on how high the overhead rate is. An overhead rate of 90% can be unreasonably high while an overhead rate of 400% can be unreasonably low, "depending on what costs are classified as direct, what costs are included in overhead, and the actual situation depicted by the nature of the costs in both categories."¹⁴⁴

B. Generally Accepted Accounting Principles¹⁴⁵

When the CAS do not apply and the procurement regulations do not prescribe a particular practice, GAAP and practices appropriate to the particular circumstances provide the rules for measuring, accumulating, and allocating costs.¹⁴⁶ GAAP' usefulness in this role is questionable. "[GAAP] were developed only to provide guides to acceptable financial accounting practices, not to cost accounting practices."¹⁴⁷ Thus, GAAP do not adequately address issues such as allocability of cost to specific cost objectives.¹⁴⁸

An additional problem is the large number of sources of authority for GAAP including: (1) substantial practice within an industry, (2) accounting textbooks and references books of individuals whose views are generally respected, (3) publications of recognized industry associations, and (4) published articles and speeches of distinguished individuals.¹⁴⁹ Trueger states that "[w]ithin this framework, contractors [have] experienced few difficulties in describing a wide variety of allocation methods as being in consonance with GAAP."¹⁵⁰

C. Terms of the Contract

The reasonableness and allowability of certain indirect costs may be difficult to determine--the cost regulations do not cover every situation and are often difficult to apply. Such uncertainty poses significant risk for both the Government and the contractor.

1. Advance Agreements

This risk can be lessened substantially by resolving questions concerning reasonableness and allowability before expenditure through an advance agreement.¹⁵¹ The Cost Principles expressly recognize the importance of an advance agreement for costs such as: use charges for fully depreciated assets, deferred maintenance, precontract costs,

independent research and development (IR&D) and bid and proposal (B&P), selling and distribution, data processing equipment, professional services, and G&A.¹⁵² "Advance agreements may be negotiated either before or during a contract but should be negotiated before incurrence of the costs involved. The agreement must be in writing, executed by both contracting parties, and incorporated into . . . [the] contract[]." ¹⁵³ Advance agreements are limited in that a contracting officer cannot agree to a treatment of costs inconsistent with the Cost Principles.¹⁵⁴

2. Limiting Clauses

Often a Government agency will limit a contractor's recovery of indirect costs on changes by including in its Changes clause a maximum overhead rate.¹⁵⁵ In addition to setting a maximum overhead rate, these clauses may limit who may recover overhead costs. Such clauses are particularly effective in limiting allowable overhead costs on changed work performed by subcontractors.¹⁵⁶ Without this limitation, the Government could pay, on a single change order, the indirect cost markups of the prime contractor, the first tier subcontractor, the second tier subcontractor, and so on.¹⁵⁷ Clauses limiting recovery of indirect costs are discussed in Chapter 2.¹⁵⁸

D. Limitations Set Forth in FAR Subpart 31.2

The basic rules for allowability of costs are set forth at FAR Subpart 31.201 through 31.204. In addition to these basic provisions, FAR Subpart 31.2, includes provisions which govern allowability of "selected costs."¹⁵⁹ The selected cost provisions govern the allowability of 50 selected costs - from public relations and advertising to relocation costs and alcoholic beverages. These provisions designate certain selected costs as allowable or unallowable, prescribe rules for cost measurement, and, in some instances, allocation. Selected costs are often indirect in nature and significant in amount.

E. Accounting for Unallowable Costs

Costs that are unallowable under the Cost Principles must be "identified and excluded from any billing, claim, or proposal."¹⁶⁰ Contractors must establish and maintain records adequate for this purpose.¹⁶¹ A cost directly associated with an unallowable cost is also unallowable and likewise must be excluded from any billing, claim, or proposal.¹⁶²

1. Unallowable Costs Included in Indirect Cost Groupings

Unallowable costs must be removed from any indirect cost grouping prior to its distribution.¹⁶³ Failure to remove unallowable costs will result in Government contracts being allocated a portion of the unallowable costs. Normally, directly associated costs included in the indirect cost grouping must be removed also.¹⁶⁴

2. Unallowable Costs in the Distribution Base

The FAR prohibits removal of unallowable costs from a contractor's distribution base.¹⁶⁵ In effect, the unallowable costs in a distribution base are allocated a proportionate share of the indirect cost grouping.¹⁶⁶ If unallowable costs are left unburdened by the indirect costs from which they benefit (if they are given a free ride), other cost objectives including Government contracts bear a share of the indirect cost grouping disproportionate to the benefits received.¹⁶⁷

CHAPTER 2

DETERMINING INDIRECT CHARGES FOR EQUITABLE ADJUSTMENTS

Chapter 1 discussed basic concepts such as the important role cost plays in pricing equitable adjustments, the behavior of cost in response to changes in volume, the allocation of indirect costs, and allowability. Chapter 2 examines how indirect cost rates are used to allocate indirect costs to change orders, how volume changes affect indirect cost rates, and whether the purpose of an equitable adjustment really is to reimburse a contractor for its out-of-pocket expenses caused by a change.

I. INDIRECT COST RATES

Indirect cost rates are used almost exclusively as the means of allocating indirect costs to changes. For this reason, a major portion of this chapter is devoted to their use. Please note, however, that some contractors do not use indirect cost rates, but charge what traditionally are considered overhead and G&A type costs directly to the change.¹⁶⁸ While acknowledging that such treatment is unusual, the boards have generally allowed the contractor to charge these expenses directly when such treatment is consistent with the contractor's normal accounting practices.¹⁶⁹

The following process normally is used to determine the amount of an equitable adjustment: (1) direct costs of the change are determined;¹⁷⁰ (2) direct costs are multiplied by an agreed upon indirect cost rate to obtain the indirect costs of the change, (3) direct and indirect costs are added together to obtain total cost of the change, (4) profit is determined by multiplying total cost by an agreed upon percentage of profit (usually 10%), (5) profit is added to total cost. Indirect costs and profit are often referred to as "markups" because of their relationship to direct costs. For purposes of convenience, boards will sometimes award a single combined markup for indirect costs and profit.¹⁷¹ This usually occurs when a contractor fails to prove its indirect cost rate adequately.

A. Projected Indirect Cost Rates

When an equitable adjustment is priced before completion of the contract or before the end of the contractor's base period, indirect costs are often assigned to the change through use of a "projected" indirect cost rate. A projected rate is necessary because the costs required to compute the actual indirect cost rate have not yet been incurred.

The accuracy with which a projected indirect cost rate will predict the indirect costs of a change depends upon the validity of a series of estimates.¹⁷² These estimates are of

two groups: (1) estimates concerning how the change will increase or decrease direct costs of performance, and (2) estimates for development of the projected indirect cost rate.¹⁷³ When these estimates are of questionable validity it may be advantageous, particularly if large dollar amounts are involved, to delay pricing the change order until the cost data necessary to compute the actual indirect cost rate are available.

A contractor normally develops a projected annual indirect cost rate for purposes unrelated to changes. The contractor may have used this rate to price the original contract. Typically, use of this rate results in a fair approximation of the indirect costs of a change.¹⁷⁴ However, when a change is significant, application of a projected annual rate may cause "over" or "under" recovery of the contractor's indirect costs.¹⁷⁵ A projected indirect cost rate allocates indirect costs accurately only at the originally estimated volume of production. The effect of volume on indirect cost rates is discussed more fully below.¹⁷⁶

B. Actual Indirect Cost Rates

Actual indirect cost rates can be computed only after the changed work is completed and the contractor's base period has ended. When actual indirect cost rates are available, the boards usually will require their use.¹⁷⁷ A surprising

amount of litigation has been generated by contractors who argue, without success, that the projected indirect cost rate used in bid preparation should be used to price a change rather than the actual indirect cost rate. Litigation usually has occurred when the contractor's bid was calculated based on lower than actual overhead costs and the change is a deletion.¹⁷⁸

C. Negotiated Indirect Cost Rates

Sometimes a contractor and the Government will negotiate a written agreement to make certain indirect cost rates available during a specified period for use in pricing contracts or modifications. Such forward pricing rate agreements (FPRA's) are projections of indirect costs and normally are negotiated only with contractors having a significant volume of Government contract proposals.¹⁷⁹

Procedures governing use and development of an FPRA are set out at FAR 15.809. In brief, a contractor submits a proposed FPRA along with supporting cost or pricing data to the administrative contracting officer (ACO). The ACO contacts audit personnel and contracting personnel who have a significant interest in the establishment of an indirect cost rate and invites them to participate in development of a Government position and in negotiations.¹⁸⁰ Negotiations take place and a formal FPRA is established. This negotiated

rate is not applied automatically to change orders. The FAR requires systematic monitoring to assure the continued validity of the negotiated rate and permits cancellation at the option of either party.¹⁸¹

D. Application of Indirect Cost Rates

An adjustment to contract price can result from work being added, deleted, substituted, or delayed. Indirect cost rates are applied differently depending upon the nature of the event necessitating the adjustment.

1. Changes Adding Work

The indirect cost rate multiplied by the increase in direct costs (caused by the change) equals recoverable indirect costs.¹⁸² The computation is very simple once the indirect cost rate and the amount of direct costs are agreed upon. A complicating factor for contracts involving more than one fiscal year is determining in which fiscal year the changed work was or will be performed. Overhead rates often vary significantly from year to year and a contractor's failure to adequately prove the period in which the change will be or was performed can be costly.¹⁸³

2. Changes Deleting Work

The Government is entitled to a downward equitable adjustment in contract price when changes deleting work decrease a contractor's costs of performance.¹⁸⁴ The indirect cost portion of the downward equitable adjustment is usually determined by multiplying the contractor's indirect cost rate by the estimated decrease in direct costs¹⁸⁵ caused by the change.¹⁸⁶ Contractor's have occasionally argued that a deletion reducing direct costs did not result in a corresponding reduction in indirect costs and therefore, use of the established indirect cost rate to determine the reduction in contract price due the Government would be inequitable. The boards have rejected these arguments.¹⁸⁷ When a relatively minor item of work is deleted, it is customary to use the price bid for the item as the amount of the equitable adjustment rather than going through the process of determining the decrease in costs and negotiating an adjustment.¹⁸⁸

3. Changes Both Adding and Deleting Work

The indirect cost portion of the equitable adjustment is determined through a four step process: (1) the increase in direct costs resulting from added work is determined; (2) the decrease in direct costs resulting from the deleted work is determined; (3) the two amounts are totalled to obtain "net"

direct costs; and (4) the indirect cost rate is multiplied by the net direct cost to obtain indirect costs of the change.¹⁸⁹ Indirect costs should be allocated to the net increase or decrease via the contractor's actual rate when available rather than its "bid" indirect cost rate.¹⁹⁰

4. Delay Related Indirect Costs

During periods of delay, direct costs performance are incurred at a reduced level, if at all. Multiplication of the direct costs incurred during the delay period by the contractor's indirect cost rate often does not compensate a contractor adequately for its indirect costs. For this reason, other methods are used to measure the indirect costs recoverable as a result of delay. Delay related recovery of indirect costs is discussed in Chapter 3.

E. Using a Standard Markup for Overhead

A standard markup for overhead often is used to determine indirect costs when inadequate evidence exists as to a contractor's actual or projected indirect cost rate.¹⁹¹ When available, actual indirect cost rates rather than a standard markup are used to determine indirect costs.¹⁹² Similarly, when a projected indirect cost rate is properly supported, it rather than the standard markup will be used to determine indirect costs.¹⁹³

Some board decisions state that the standard markup for overhead on construction contracts is 10%,¹⁹⁴ other board decisions that the standard markup is 15%.¹⁹⁵ The 10% rate is more commonly used.¹⁹⁶ On occasion, boards have adjusted the standard indirect cost rate upward or downward to accommodate unique circumstances.¹⁹⁷ For example, in *Trans-Eastern Constructors*, the ASBCA, after hearing testimony from a Government estimator that it was permissible to vary the standard overhead rate upward or downward depending upon the circumstances, raised the markup to 20% to compensate a subcontractor for the delays, false starts, rework and reassembly caused by the change.¹⁹⁸

When a standard markup for indirect costs is used, boards have not allowed contractors to charge overhead type items as direct costs.¹⁹⁹

F. Clauses Limiting Recovery of Indirect Costs

Some contracting agencies supplement the Changes clause and the Differing Site Conditions clause, placing limits on the amount of overhead and profit recoverable.²⁰⁰ The limits apply only to equitable adjustments claimed under the Changes clause or Differing Site Conditions clause. The supplemental terms usually (1) limit overhead and profit, each, to 10% of the direct costs of the change,²⁰¹ (2) establish who may

recover overhead, commission, and profit on changed work performed by subcontractors, and (3) establish which costs constitute direct costs of a change.²⁰² This practice has been successful in limiting recovery of indirect costs despite frequent litigation by contractors.²⁰³ Contractors often attempt to get around the limits by charging costs, typically indirect in nature, as direct costs of the change. These attempts are rarely successful.²⁰⁴

II. How Volume Affects Indirect Cost Rates

A change order will not affect the amount of fixed costs incurred by a contractor because these costs remain the same (within the relevant range of production) regardless of changes in volume. However, as volume increases the amount of fixed cost per unit of production decreases.²⁰⁵ For example, a contractor buys a machine for \$10,000 that will be obsolete after one year. If the contractor produces 10 units on the machine, the cost of the machine is \$1000 per unit. If the contractor produces 20 units, the cost is \$500 per unit; 50 units--\$200 per unit, and so on. The amount of fixed cost per unit of production varies in inverse proportion to the number of units produced.

When a change substantially increases or decreases the volume of production, use of indirect cost rates based on original

volume projections may lead to "over" or "under" recovery of indirect costs.

Example:

Contractor A computes its projected indirect cost rate for fiscal year 19X9 as follows. It estimates production of 10 million units, direct costs of \$2 per unit, variable indirect costs of \$1 per unit, and fixed indirect costs of \$20 million. Its projected indirect cost rate is calculated as follows:

Indirect Cost Grouping

Variable indirect costs (10 million units X \$1 per unit)	\$10 million
Fixed indirect costs	<u>\$20 million</u>
Total indirect costs	\$30 million

Distribution Base

Direct Costs (10 million units X \$2 per unit)	\$20 million
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<u>Indirect cost Rate</u> (\$30 million/\$20 million)	150%
--	------

At 10 million units of production, this indirect cost rate fully distributes indirect costs to production. However, if the volume is more or less than 10 million units, application of the projected rate results in over or under recovery of fixed indirect costs. For example, assume that receipt of a change order adds 2 million units to the contractor's estimated volume of 10 million units. This increase in volume will cause the projected indirect cost rate to decrease from 150% to 133%.²⁰⁶ Use of the originally

projected rate (150%) in costing the change results in the change absorbing more than its proportionate share of fixed indirect costs (\$666,667 more).²⁰⁷ Similarly, application of the originally projected rate to a change reducing volume results in under recovery of fixed indirect costs.

Actual indirect cost rates should be calculated and used to determine indirect costs whenever the cost data is available to calculate them.²⁰⁸ When, however, a change is priced before the end of the accounting period or prior to performance of the change, a projected indirect cost rate must be used. Professors Cibinic and Nash suggest recomputation of the projected indirect cost rate, based on new volume estimates, for major dollar changes.²⁰⁹

III. DO EQUITABLE ADJUSTMENTS DO MORE THAN MAKE A CONTRACTOR WHOLE?

Obviously, a contractor should be compensated for any increased costs caused by an event entitling it to an equitable adjustment.²¹⁰ As explained in Chapter 1, costs which increase or decrease as volume changes are called variable costs--entitlement to these is clear. The question is whether a contractor should receive increased compensation for its fixed costs which do not increase as volume changes.

The Court of Claims has stated that the objective of an equitable adjustment is "to keep a contractor whole"²¹¹--to "leave the contractor in the same financial condition as it would have been if the change order had not been issued."²¹² Variable costs alone increase or decrease in response to changes in volume.²¹³ Therefore, if the purpose of an equitable adjustment were, as has often been stated by the boards of contract appeals, "to compensate the contractor for the unanticipated and extra out-of-pocket expense it incurred in performing the contract as a result of the changes,"²¹⁴ only variable costs would be considered in pricing a change. Direct costing rather than full costing would be used to price changes.²¹⁵

A. Effect of Using Full Costing Rather Than Direct Costing

Assume a change increases a contractor's costs by \$1500; the Government adds \$150 for profit (10% of costs)²¹⁶ and pays the contractor \$1650 for the change. It is hard to argue that the contractor has not been made whole.²¹⁷ Using full costing principles and assuming a fixed indirect cost rate of 100%, in the situation above, the contractor will receive \$3300 (\$1500 variable costs + \$1500 fixed indirect costs + \$300 profit). Receipt of \$3300, when incremental costs of performance were only \$1500, is a lot more than simply being made "whole."

Assume instead the change decreased the contractor's costs of performance by \$1500. Using full costing principles, the contract price will be reduced by \$3300 (\$1500 variable costs + \$1500 fixed indirect costs + \$300 profit). Again, it is difficult to argue that the contractor has been kept whole by a \$3300 price reduction when its costs were reduced by only \$1500.

Full costing puts a contractor with excess production capacity who would like to maximize its profit in a particularly precarious position.²¹⁸ There is significant risk in bidding a Government contract at less than full cost for the purpose of maximizing profit. If after award, the Government issues a change order deleting work or the contractor encounters a differing site condition which significantly reduces direct costs, the contractor could find itself in a significant loss situation. Under full costing, the contract price is reduced by the full cost of the change including a full share of fixed indirect costs even though the bid amount was intended to maximize profit by allowing full recovery of variable costs and some contribution toward fixed costs.

The only time full costing places a contractor in the same position as it would have been in but for the change is when a contractor is working at full capacity and (1) the

additional work required by the change takes the place of "other work" that could have been priced to permit recovery of fixed overhead, or (2) deletion of work allows the contractor to perform replacement work at a price permitting recovery of fixed overhead. In sum, full costing puts a contractor back in the position it would have been in absent a change only when the contractor is working at full capacity and substitute work is available that can be priced at a level permitting full recovery of fixed overhead.

Despite the fact that full costing rarely results in a contractor being put back in the position it would have been in but for the change, it is the costing method used to price adjustments. In fact its use is so well established that the major texts on Government accounting do not even raise the issue of whether direct costing provides a better measurement of the parties' altered financial position.²¹⁹

B. Why Full Costing Is Used

The reasons full costing is used to price adjustments are:

(1) Full costing is the costing method used when the original contract price is determined through negotiation. In addition, it is used to determine cost for "cost reimbursement" type contracts.²²⁰ Familiarity with its use

probably led to the assumption that its use would be appropriate for equitable adjustment purposes.

(2) Use of direct costing could lead to ridiculous results. Assume, for example, a contract price of \$22,000 (variable costs \$10,000, fixed overhead \$10,000, and profit \$2000 [10% of total costs]). A change order deleting 80% of the contract work reduces variable costs by 80%. An equitable adjustment based on direct costing would reduce the contract price by only \$8800 (\$8000 variable costs + \$800 profit). The Government would pay \$13,200--60% of the original contract price for 20% of the originally contracted for work (probably an unreasonably high price for the work performed). Assume on the other hand, a change order doubles the contractor's work. Under direct costing, the contractor would receive \$11,000 additional compensation (\$10,000 variable cost + \$1000 profit). Although, the equitable adjustment increased the contract price by \$1000 more than the contractor's costs increased, the added work includes no amount for fixed overhead, and thus, may be priced much lower than the contractor would ever consider pricing it.

(3) If direct costing were used to price equitable adjustments, contractors with cost reimbursement type contracts would be adversely affected. The amount of fixed indirect cost properly allocable to cost reimbursement contracts is governed by the Cost Principles.²²¹ The Cost

Principles require that indirect costs be allocated "on the bases of benefits accruing to the several cost objectives"²²² and prohibit fragmentation of an accepted distribution base by removal of individual elements of the base.²²³ What this means is that the direct costs of the changed work will not be removed from the contractor's distribution base and a proportionate share of the indirect cost grouping (including fixed indirect costs) will be allocated to the work performed under the equitable adjustment regardless of whether the equitable adjustment was priced to include fixed indirect costs.

C. The Real Objective of an Equitable Adjustment

The objective of an equitable adjustment is not to make the contractor whole or put it in the position it would have been in absent the change, despite the numerous cases so stating. The objective of an equitable adjustment is to pay the contractor the price that the contractor would have received for the changed work, had the changed work been the subject of a separately negotiated contract. If the true objective of an equitable adjustment were to make the contractor whole or put the contractor in the position it was in prior to the change, the courts and boards would focus only on the incremental costs of a change. In tort, where the objective really is to put the injured party back in the position he or

she would have been in but for the tort, the focus is on the injury suffered--the "but for" costs.

Note that no authoritative pronouncements exist on how equitable adjustments are to be calculated. The question concerning which method of costing should be used to price equitable adjustments has not been addressed by regulation or GAAP. Paul M. Trueger, in *Accounting Guide For Government Contracts*,²²⁴ comments on the failure of drafters of the procurement regulations and the accounting profession to develop cost determination principles for equitable adjustment claims arising out of changes and delays. He states that one can "probe deeply into procurement regulations and accounting literature without finding any authoritative or even informative guidance in these areas."²²⁵

CHAPTER 3

UNABSORBED OVERHEAD

The purpose of this chapter is to discuss recovery of indirect costs in delay situations where the normal method of recovering indirect costs--through use of an indirect cost rate--does not equitably measure indirect cost. Chapter 3 begins by discussing how delay affects cost and then discusses the concepts of unabsorbed and extended overhead.

I. HOW DELAY AFFECTS CONTRACTORS

Delay often increases the direct costs of performing a contract. Increased direct costs may result from: (1) delay until a time when labor and material prices are higher, (2) standby of labor and equipment because the ability to perform might be lost were these costs discontinued and because it is impractical to make other use of the labor and equipment, and (3) less efficient production after resumption of work due to loss of personnel, learning curve interruption, performance of work out of sequence, shift of work from good weather to bad, shut-down and start-up costs, work area congestion, and rehandling of materials.

Delays of the same aggregate number of days may vary in their effect on direct cost depending upon the nature and timing of the delay. Delays may be short and intermittent, partial

or complete, may occur before performance begins, in the midst of performance, or near completion of performance. The contractor's peculiar circumstances and the nature of the contract itself determine the effect of a delay.

A contractor is entitled to recover its increased direct and indirect costs caused by a **compensable** delay.²²⁶ As explained in Chapter 2, indirect costs are usually recovered as a percentage markup on direct costs.²²⁷ However, during a delay, the relationship between incurrence of direct costs and fixed indirect costs changes. During delay, direct costs are incurred at a reduced level, if at all.²²⁸ Variable indirect costs also are incurred at reduced levels during periods of delay. In contrast, **fixed indirect costs** are **unaffected** by delay and continue to be incurred at normal rates throughout the delay period. Recovery of fixed indirect costs through methods other than the normal percentage markup on direct costs is discussed below.

II. UNABSORBED/EXTENDED OVERHEAD

A. Defining Unabsorbed and Extended Overhead

1. Unabsorbed Overhead

Unabsorbed overhead is the amount of indirect expense actually incurred that would have been allocated to the contract had the delay not occurred and is not recovered in revenue from any other work. Thus what

is involved here is a lower contract allocation base (or none at all if the contract work has stopped) in a situation in which indirect costs continue but no other work is substituted for the contract work not performed during the delay period.²²⁹

This definition suggests that unabsorbed overhead exists only when there is a delay. While unabsorbed overhead usually arises as a result of delay, changes to a contract that extend the period of contract performance can create unabsorbed overhead also, as can differing site conditions. For example, unabsorbed overhead results when a change extends the period of contract performance, it is impractical for the contractor to obtain other work during the period of extension, and the direct costs generated by the change are insufficient to absorb the contractor's fixed indirect costs during the period of extension.

The term "underabsorbed overhead" is used as a synonym for unabsorbed overhead.

2. Extended Overhead

A primary reason for the confusion surrounding recovery of fixed indirect costs has been the failure to properly define and distinguish the concepts of unabsorbed overhead and extended overhead.²³⁰ Despite the fact that the two concepts are distinct²³¹ and the basis of recovery for each differs, boards and commentators often use them synonymously.²³²

Boards and commentators frequently comment that "extended overhead has as its premise that mere extension of the performance period increases overhead costs."²³³ This inartful comment has created a significant amount of confusion. Extension of the performance period does not increase the fixed costs for which recovery is sought. Those costs would have been incurred had the contract not been extended. Analytically, the basis for recovery of extended overhead is that the Government received a benefit in the form of increased home office effort due to extension of the period of contract performance.

B. Entitlement to Unabsorbed and Extended Overhead

To recover either unabsorbed or extended overhead, a contractor must prove: (1) the Government caused a delay, (2) the delay was not concurrent with a contractor-caused delay or a delay caused by events for which the contractor is responsible under the terms of the contract, and (3) the contractor was injured by the delay (its costs were increased).²³⁴ The first two elements of proof, while factually important to recovery, are easily understood. It is the injury in fact element which creates conceptual difficulties.

1. Unabsorbed Overhead

As explained above, delay does not increase fixed indirect costs. Delay may, however, reduce the distribution base in the accounting period in which the delay occurs.²³⁵ If so, each unit of work performed during the accounting period will bear a higher proportion of fixed indirect cost than it would have had the delay not occurred. Profit for the accounting period will be reduced in the amount of the unabsorbed overhead.

As a prerequisite to recovery of unabsorbed overhead, boards and courts generally have required proof that the delay reduced the contractor's distribution base.²³⁶ Usually a showing that it was impractical to obtain substitute work and that substitute work, in fact, was not obtained is sufficient.²³⁷ Once the contractor shows that it would have been impractical to have obtained substitute work during the delay, the burden of going forward with proof that the contractor suffered no loss or should have suffered no loss shifts to the Government.²³⁸ Contractors need not prove with specificity what work they failed to bid on or would have obtained but for the delay.²³⁹

2. Entitlement Where Delay Does Not Ultimately Reduce the Contractor's Distribution Base

A contractor, working at less than full capacity which does not lose other work as a result of delay, will experience unabsorbed overhead (a reduced distribution base) in the period of delay and overabsorbed overhead (an increased distribution base) in the following period when the contract is completed. The delay merely shifts performance from one accounting period to another. Over the life of the contract (in contrast to individual accounting periods) the contractor will experience no reduction in its distribution base as a result of the delay. The delay does not reduce or increase volume of production except as between accounting periods. When the period of delay and period of completion are viewed as a single period the contractor's profit/loss position is unaffected by the delay. Thus, unless the contractor was unable to take other work because of the delay it should not be entitled to recover unabsorbed overhead.²⁴⁰

As Professors Nash and Cibinic point out, the unabsorbed overhead in the period of delay must be balanced against the overabsorbed overhead in the period of completion to accurately determine the effect of the delay.²⁴¹ When unabsorbed overhead in the period in which a delay occurs is off set against overabsorbed overhead in the period of completion, this usually results in a "net" unabsorbed or

overabsorbed overhead. A contractor should not recover for any net unabsorbed overhead it may experience. The reason is that the net over or under absorption of overhead does not effect cost except as between periods. Net over or under absorption of overhead is caused by volume changes unrelated to the delay.²⁴²

3. Extended Overhead

A contractor that requests an adjustment for unabsorbed overhead is seeking recovery for a decrease in its distribution base.²⁴³ In contrast, a contractor that requests an adjustment for extended overhead cannot validly claim that its distribution base has been reduced.²⁴⁴ And, although its home office personnel may have been involved with additional monitoring and administration of the delayed contract, its home office costs were not increased by the delay because home office costs are normally fixed costs.²⁴⁵ A contractor claiming extended overhead can show that because of the delay the contract received more benefit from home office costs than it would have had the delay not occurred. Thus, a contractor claiming extended overhead really seeks compensation for this increased benefit.²⁴⁶

The issue, which is as yet undecided,²⁴⁷ is whether a contractor is entitled to an equitable adjustment merely because its fixed indirect costs benefited the delayed

contract more than originally anticipated. Confusion exists because the boards and courts have failed to analyze clearly the concept of extended overhead.²⁴⁸ Upon analysis, if extended overhead is determined to be based on benefit rather than increased cost its recovery will probably be denied. The reason is that the parties have contractually agreed to make adjustments to the contract price in only certain circumstances--all of which are contingent upon delay increasing the costs of performance. The oft-stated purpose of an adjustment is to pay a contractor for any increase in costs caused by the event necessitating the adjustment--not to pay the contractor for the increased benefit the Government may have received from its services.²⁴⁹ Not surprisingly, boards and courts have made entitlement to unabsorbed overhead contingent upon a finding of increased cost.²⁵⁰ In the absence of such a finding, entitlement has been denied.²⁵¹

Arguably, increased benefit can be expressed in terms of increased cost so as to permit additional recovery. The argument is made as follows. Although the contractor's fixed indirect costs do not increase as a result of the delay, the delayed contract's allocable portion of fixed indirect costs becomes greater as the benefit it receives from fixed indirect costs increases. Simply put: (1) the contractor's bid includes an allocation for fixed indirect costs based on the contract being performed without delay--this allocation

is a contract cost; (2) the allocation is based on the anticipated beneficial relationship between the contract and fixed indirect costs; (3) because of the delay the contract benefited more from fixed indirect costs than anticipated; (4) therefore, more fixed indirect costs are associated with the contract; (5) the more fixed indirect costs associated with the contract the more the contract costs to perform.

Despite the arguable ability to equate benefit with cost the fact remains that extended overhead unlike unabsorbed overhead does not alter the contractor's financial position. Although a contractor can contend that it would have included more home office costs in its bid had it known the contract would be delayed, the contention is strained due to the number of speculations involved. First, would the contractor, in fact, have increased its price--the extension does not increase the contractor's out-of-pocket cost for fixed indirect cost items nor is it the contractor's established cost accounting practice to allocate indirect costs to contracts based on their length. Second, if the contractor had increased its bid would it still have obtained the contract? The delay would not increase the fixed indirect costs of any other bidder. Competition, probably, would have kept the contractor from increasing its bid even if it had known that the contract would be delayed. For this reason, extended overhead should be denied--it does not represent a real loss in contrast to unabsorbed overhead.

Nevertheless, extended overhead is sometimes awarded.²⁵² For example, in *Able Contracting*,²⁵³ the contractor was permitted to recover home office overhead even though the contractor could have performed another job during the period of delay. The delay did not make it impractical for the contractor to take on other work; other work was simply not available as indicated by the contractor's large amount of unused capacity. The question, left unanswered by the *Capital Electric* decision²⁵⁴--whether extended overhead is recoverable--was not addressed in the *Able Contracting* decision. The Government failed to raise the issue.

Cases holding that fixed overhead costs are recoverable absent proof that the contractor's distribution base has been reduced are difficult to find.²⁵⁵ Either the issue is not raised or there is a finding that the delay made it impractical for the contractor to perform other work. Therefore, while some cases ostensibly permit recovery of "extended" overhead, it is difficult to discern whether they are permitting recovery of extended overhead or using the word extended overhead as a synonym for unabsorbed overhead.²⁵⁶

Before the Federal Circuit Court of Appeal reversed *Capital Electric* and *Savoy Construction*, in all but one of the board cases in which the issue was raised, recovery of extended

overhead was denied.²⁵⁷ However, the reversal in *Savoy Construction*, has cast a shadow on their continuing validity.²⁵⁸ In a recent case, *G.S. and L. Mechanical and Construction*, the DOT BCA rejected the Government's contention that recovery of fixed indirect costs is predicated upon proof that the contractor would have been prevented from taking on additional work had there not been a delay.²⁵⁹

4. The Rationale Supporting Extended Overhead as a Separate Basis of Recovery

Extended overhead is an attractive theory of recovery for fixed indirect costs because it provides additional compensation for fixed indirect costs every time the period of contract performance is extended as a result of Government caused delay. Unlike unabsorbed overhead, recovery of extended overhead is not contingent upon proof that the contractor's distribution base has been reduced--that the delay prevented the contractor from taking on other work. Extended overhead, if allowable, would enable contractors with excess capacity to recover additional fixed indirect costs merely because a Government-caused delay extended contract performance.

Some commentators view extended overhead as a concept unique to construction contracting and unabsorbed overhead, in

contrast, as a concept applicable only to manufacturers.²⁶⁰ The basis for this distinction is that, in the short-run, a manufacturer has only a fixed amount of factory space and, as a result, limited capacity. A manufacturer whose contract is delayed is enabled by the delay to take on other work. Taking on other work in effect mitigates the loss.²⁶¹ In contrast, a construction contractor's capacity to perform work is not limited by the size of its facilities.²⁶² Its jobsite can be anywhere. Theoretically, a construction contractor can perform an almost infinite number of jobs. Therefore, additional work performed during a delay is not in substitution of the delayed contract--it would have been performed had the contract not been delayed. Thus, performance of such work does not mitigate the loss of other work.

The distinction is faulty for two reasons. First, contractors have a relatively fixed capacity the same as manufacturers--although perhaps to a lesser degree. Three important limitations are (1) capital, (2) knowledge and availability of quality subcontractors and (3) ability to obtain bonding.²⁶³ Second, extended overhead is not unique to the construction industry. Even though a manufacturer obtains substitute work, it also must administer the delayed contract during the period of delay. Therefore, if extended overhead is recoverable at all, it should be recoverable by manufacturers as well as construction contractors. Singling

out construction contractors for this special remedy is unsound. The contention that Government should provide a special remedy for construction contractors merely because they had the capacity to perform additional work prior to the delay--unlike the manufacturer--is ridiculous.

Note that a construction contractor with excess capacity, may incur unabsorbed overhead²⁶⁴ in circumstances where a manufacturer with a fixed capacity would not (such as when a manufacturer is enabled by the delay to obtain substitute work and does).²⁶⁵ Even under these circumstances, the construction contractor should not be singled out for a special remedy. Any unabsorbed overhead the construction contractor experiences during the accounting period in which the delay occurs will be offset by overabsorbed overhead in the accounting period in which the delayed work is performed.²⁶⁶

5. Entitlement Under Various FAR Clauses

Recovery of equitable adjustments is governed by contractual clauses contained in the FAR. A contractor's entitlement to unabsorbed overhead is affected by which one of several FAR clauses permits its recovery. Clauses under which unabsorbed overhead may be recovered include: (1) Suspension of Work clause,²⁶⁷ Stop-Work-Order clause,²⁶⁸ Government Delay of

Work clause,²⁶⁹ Changes clause,²⁷⁰ Differing Site Conditions clause,²⁷¹ and Termination for Convenience clause.²⁷²

Under the Suspension of Work clause, a contractor is entitled to unabsorbed overhead for unreasonable periods of delay only and is not entitled to profit on unabsorbed overhead;²⁷³ similarly, under the Government Delay of Work clause a contractor is not entitled to profit on unabsorbed overhead. These limitations do not apply to other contract clauses. Therefore, whenever possible, contractors will attempt to recover unabsorbed overhead costs under the Stop-Work-Order clause, Changes clause, Differing Site Conditions clause, or Termination for Convenience clause.²⁷⁴

Contractors usually do not experience unabsorbed overhead as a result of a change or differing site condition and, therefore, normally receive adequate compensation for their fixed indirect costs through use of their normal percentage markup on direct costs.²⁷⁵ However, if a contractor proves that its distribution base was reduced as a result of a change (that its normal percentage markup on direct costs does not provide adequate compensation) recovery of unabsorbed overhead is permitted.²⁷⁶ Note that delays preceding issuance of a change order (delays unrelated to the actual performance of the changed work) are generally recoverable under the Suspension of Work clause rather than the Changes clause.²⁷⁷

C. Measuring Unabsorbed Overhead

1. A Parade of Formulas

The process of finding a substitute for the normal practice of allocating indirect costs as a percentage markup on direct costs has been a long one. Numerous formulas and variations thereof have been used or recommended to approximate a contractor's unabsorbed overhead cost including: *Eichleay*,²⁷⁸ modified *Eichleay*,²⁷⁹ *Allegheny*,²⁸⁰ *A.C.E.S.*,²⁸¹ *Carteret*,²⁸² *Allied Materials and Equipment*,²⁸³ and simulation.²⁸⁴ Each formula is set out in Appendix 2. The formulas vary in their ability to approximate true unabsorbed overhead. Only in limited circumstances will any of the formulas correctly approximate true unabsorbed overhead.

Unabsorbed overhead can be determined without resort to a formula in much the same way that other increased costs are determined. This chapter recommends such an approach.

2. The Eichleay Formula

a. Background

For over 25 years, boards and courts have used the *Eichleay* formula or some variation thereof to calculate unabsorbed

overhead costs. Other formulas have been used, but the *Eichleay* formula is the prevailing method used by the boards of contract appeals.²⁸⁵ Contractors favor the *Eichleay* formula for two reasons. First, it is simple to use; its mechanical application frees a contractor from having to prove actual unabsorbed overhead. Second, the *Eichleay* formula generally provides a higher recovery than most other formulas. In recent years there has been a growing disenchantment with the *Eichleay* formula. There has been a growing awareness that the formula does not accurately measure actual unabsorbed overhead.²⁸⁶

In *Capital Electric*, the GSBCE found that the common law of construction contracts did not allow recovery of extended overhead--but did allow recovery of unabsorbed overhead.²⁸⁷ Furthermore, the GSBCE found that the *Eichleay* formula was an improper measure of unabsorbed overhead; it found the fluctuating burden method the proper formula for measuring unabsorbed overhead.²⁸⁸

The Court of Appeals for the Federal Circuit reversed the GSBCE decision.²⁸⁹ The Federal Circuit sidestepped the issue of whether extended overhead was recoverable. It held that Capital Electric had introduced un rebutted evidence of its inability to take on substituted work during the various delay periods.²⁹⁰ Thus, Capital Electric had established its entitlement to unabsorbed overhead, eliminating the need for

the Federal Circuit to decide whether extended overhead was recoverable. The Federal Circuit also held that the Court of Claims' decision in *Fred R. Comb Co. v. United States*²⁹¹ holding that the *Eichleay* formula was a proper measure of damages for unabsorbed overhead created binding precedent for the boards of contract appeals.²⁹² The Federal Circuit then commented that the *Eichleay* formula had been followed in so many board decisions, that a determination that it was an improper measure of damages should more properly be left to Congress rather than the Federal Circuit.²⁹³

On the same day that it reversed *Capital Electric*, the Court of Appeals for the Federal Circuit also decided an ASBCA case, *Savoy Construction v. United States*.²⁹⁴ Here, a construction contractor received change orders which increased its contract performance time by 273 days. The change orders generated additional direct costs of over \$600,000. The contractor contended that the 3.7 to 10 percent markups on the additional direct costs provided insufficient compensation for its 273 days of additional contract administration and sought to recover additional home office costs under the *Eichleay* formula. The Board denied such recovery holding that entitlement to unabsorbed overhead was predicated on proof that the contractor's distribution base had been reduced.²⁹⁵ The Claims Court, characterizing the claim as one for extended overhead, agreed with the Board that proof that the contractor's distribution

base had been reduced was a prerequisite to recovery.²⁹⁶ In an unpublished opinion, the Court of Appeals for the Federal Circuit reversed. What the Savoy reversal means is unclear. In *Excavation-Construction*,²⁹⁷ the ENG BCA addressed this issue.

Unfortunately, it appears that the distinction between the two different types of cases may not have been brought to the attention of the United States Court of Appeals for the Federal Circuit when the *Capital Electric* and *Savoy* cases were reviewed by that Court However, the Court's Savoy ruling is not citable as precedent and the issue may yet receive a thorough airing.²⁹⁸

Commentators have not interpreted the reversals to mean that the Court of Appeals for the Federal Circuit has endorsed the automatic application of the *Eichleay* formula or as having settled the criticisms leveled against use of the formula. They see the *Eichleay* formula as remaining vulnerable to attack and caution against its blind application, particularly where entitlement is not clear.²⁹⁹

Since *Capital Electric* and *Savoy Construction*, the boards and courts have decided a number of cases in which contractors have sought recovery under the *Eichleay* formula.³⁰⁰ The cases are mixed in their interpretation of *Capital Electric* and *Savoy Construction*. For example, in *G.S. and L. Mechanical and Construction*, the DOT CAB after seriously questioning the validity of the *Eichleay* formula states:

It is in recognition of these failings that certain Boards seem to have withdrawn from their earlier endorsements of the Eichleay principle. Even the majority opinion in *Capital Electric*, above, appears to be inviting litigants, in an appropriate case to have the Court of Appeals conduct an *en banc* review of the Eichleay approach.³⁰¹

In contrast, in *Don Cherry, Inc.*, the ASBCA treated the matter as settled and summarily dismissed the Government's arguments against use of the *Eichleay* formula commenting, "Much of the steam has been taken out of the Government's arguments by the Federal Circuit Court's decision in *Capital Electric Co. v. United States* and the Board decisions which have followed."³⁰² In *Ricway, Inc.*, the Board went even further stating, "Failure to apply [the *Eichleay* formula] has been strongly rejected by the Court of Appeals for the Federal Circuit in *Capital Elec. Co. v. United States*."³⁰³

b. The Eichleay Formula

The *Eichleay* formula calculates an average daily amount of fixed indirect cost allocable to the delayed contract. This per diem amount is then multiplied by the number of days of compensable delay to obtain the amount of unabsorbed overhead. The *Eichleay* formula usually consists of the following three steps:

<u>Contract billings</u> Total billings for the actual contract period	X	Total overhead incurred during period	= Overhead allocable to the contract
<u>Allocable overhead</u> Actual days of contract performance			= Overhead allocable to the contract per day
Daily overhead	X	Number of days delay	= Unabsorbed overhead

c. Criticisms of Eichleay

The *Eichleay* formula is based upon a number of presumptions, the correctness of which determine the formula's accuracy and usefulness. These presumptions are: (1) a proportional relationship exists between contract billings and fixed indirect costs; (2) the indirect cost pool includes only fixed costs; (3) the contractor does not perform any substituted work of value during the delay; (4) the contractor was otherwise working at full capacity during the entire period of contract performance; (5) the effect of a delay on a contractor is the same regardless of when the delay occurs; and (6) the period of contract performance is an acceptable base period for accumulating fixed indirect costs.

The first presumption--that a proportional relationship exists between contract billings and fixed indirect costs--is questionable. Contract billings are seldom used as a distribution base for indirect costs for good reason. A

contract billings distribution base is simply a cost of sales base plus a profit element and not surprisingly has the same defects as a cost-of-sales base (discussed in Chapter 1).³⁰⁴ However, billings are even less accurate than cost-of-sales in distributing indirect costs in proportion to the causal or beneficial relationship existing between a contract and the indirect cost pool or in relation to the total activity of the business as a whole.³⁰⁵ This is because the amount of profit included in billings varies by contract and not necessarily in proportion to the beneficial or causal relationship existing between the contract and the indirect cost pool or in proportion to the total activity of the business as a whole.

The second presumption--that the indirect cost pool does not include any variable costs--should not be accepted without verification. Even home office costs, normally thought of as fixed, sometimes include variable elements.³⁰⁶ "To the extent that a claim includes expenses that vary over time, the *Eichleay* formula does not reliably measure the contractor's actual loss."³⁰⁷ The fixed/variable issue has not caused much litigation probably because home office costs are fixed in most instances.³⁰⁸ However, both the Government and the contractor should be sensitive to this limitation of the *Eichleay* formula and examine home office costs and other indirect cost pools for which unabsorbed overhead is being

calculated, prior to use of the formula, to identify and remove variable indirect costs.

The third presumption--that the contractor, during the delay, does not perform any substituted work of value--should be carefully scrutinized whenever recovery is claimed under the *Eichleay* formula. The fact that it was impractical for the contractor to take on a project the size of the delayed contract does not mean that the contractor's work force was completely idle and provided no benefit to the contractor.³⁰⁹ Substituted work mitigates a contractor's damages; it reduces unabsorbed overhead.³¹⁰ The *Eichleay* formula does not properly credit the delayed contract with this mitigation.³¹¹ Thus, its application results in over recovery of unabsorbed overhead whenever substituted work is performed.³¹² The more substituted work performed, the greater the over recovery.³¹³ For this reason, it is very important for the Government to establish just what work was performed during the delay period and to reduce the contractor's recovery of unabsorbed overhead accordingly.

The fourth presumption--that the contractor was otherwise working at full capacity during the entire period of contract performance--also should be scrutinized carefully before applying the *Eichleay* formula. Assume a contractor that has already begun its work on a Government contract finishes one large commercial contract and bids on, but fails to get, a

replacement contract. The Government contract is then delayed. Because the contractor failed to get a replacement contract for its commercial project, the Government's share of the contractor's total billings for the period of contract performance is increased, perhaps substantially. And because the *Eichleay* formula computes unabsorbed overhead as a percentage of total billings, the contractor's recovery from the Government is likewise increased.³¹⁴

Thus, the *Eichleay* formula permits recovery of unabsorbed indirect costs in amounts that a contractor would never have been able to recover in a competitively priced bid. Unabsorbed overhead, not caused by the Government, also occurs when a contractor's commercial work is delayed for reasons unrelated to the Government contract. Here again, the Government's proportional share of the contractor's billings is increased, resulting in the contractor recovering under the *Eichleay* formula a greater amount of unabsorbed overhead from the Government.

The fifth presumption--that the effect of delay on a contractor is the same regardless of when the delay occurs³¹⁵--is unsound.³¹⁶ The timing of a delay determines its impact on a contractor. A delay which occurs during the winter, when a construction contractor is less productive and probably has a smaller crew, will have less effect on the contractor than a delay which takes place during the peak

summer months. Which members of a contractor's work force and which equipment items are idled often depend on when the delay occurs during contract performance. Nonetheless, regardless of the timing of a delay, the *Eichleay* formula provides the same measure of recovery. Similarly, the *Eichleay* formula does not accurately measure the effects of a delay from the standpoint of the administrative effort expended by a contractor. The level of administrative effort is not constant throughout contract performance. More home office effort is usually needed at the beginning and end of a contract performance than at other times.³¹⁷ And, during periods of extended inactivity, although reports and certain administrative tasks continue, a contract needs less home office attention than during periods of peak performance.³¹⁸

The sixth presumption--that the period of contract performance is an acceptable base period for accumulating fixed indirect costs (i.e., is representative of normal operations)--will be valid in most circumstances. Chapter 2 explained that a base period of one year is normally required by the procurement regulations.³¹⁹ The reason is that periods of less than one year are subject to seasonal and other variations which do not accurately reflect the normal operations of the contractor's business.³²⁰ Periods longer than one year can attenuate the relationship between indirect costs and the direct costs which generated them, especially when a significant change in the contractor's operations

occurs.³²¹ However, fixed indirect costs are less subject to seasonal fluctuations and significant change than variable costs. Nonetheless, the degree to which costs are fixed vary³²² and both the Government and the contractor should be sensitive to this limitation of the *Eichleay* formula.

The analysis above shows that use of the *Eichleay* formula will often result in over recovery of unabsorbed overhead--a windfall for the contractor.³²³ However, when the presumptions are valid use of the *Eichleay* formula will result in under recovery of unabsorbed overhead.³²⁴

The *Eichleay* formula employs a ratio reflecting the relative value of a delayed contract to the value of all work that the contractor performed during the delayed contract's actual period of performance. Thus, the ratio's denominator includes the value of work performed between the delayed contract's scheduled and actual completion dates. The numerator, however, includes only the value of the delayed contract. It does not include the value of projects postponed because of the delay, projects that would, but for the delay also bear a share of the contractor's fixed home office expenses.³²⁵

The *Eichleay* formula can be modified to avoid under compensation. The following is one of several ways to modify the *Eichleay* formula to avoid under compensation:³²⁶

$$\frac{\text{Delayed Contract's Value for Normal Period}}{\text{Total Value of All Contracts for Normal Period}} \times \text{Total Fixed Home Office Expenditures For Period of Delay} = \text{Allocable Home Office Overhead}$$

The difference between the amount of recovery under the *Eichleay* formula and the amount of recovery under the modified version of the *Eichleay* formula can be substantial. For example, the modified version would have allowed the contractor in *Capital Electric*, to recover \$466.52 in daily overhead for each day of delay, rather than the \$311 it did recover under the *Eichleay* formula.³²⁷

The boards and courts are reluctant to grant recovery under the modified *Eichleay* formula.³²⁸ Undoubtedly this reluctance is caused, in part, by the strong criticism that the *Eichleay* formula has attracted. Because the *Eichleay* formula's ability to correctly measure unabsorbed overhead is dependent upon the validity of a large number of presumptions, any one of which if not valid will result in over recovery, the modified *Eichleay* formula should be used sparingly, if at all.

d. Alternative to Formulas Such as Eichleay

The assumption that a contractor cannot be expected to prove actual unabsorbed overhead costs is implicit in the many decisions using the *Eichleay* formula or other formulas to measure unabsorbed overhead. Surprisingly, there is very little analysis explaining why actual damages cannot be proven. The task of proving actual damages is only slightly more difficult than proving a projected indirect cost rate or

the credit due the Government when work is deleted from a contract.³²⁹

(i). Unabsorbed Overhead. The steps necessary to determine actual unabsorbed overhead are:

1. Estimate the amount by which the Government caused delay reduced the distribution base.
2. Estimate the amount by which other events reduced the distribution base.
3. Add the reductions to the actual distribution base for the period to obtain the contractor's adjusted distribution base.
4. Divide fixed home office expense for the accounting period by the adjusted distribution base to obtain the home office overhead rate.
5. Multiply the home office overhead rate by the reduction in the distribution base caused by the Government delay to obtain the amount of unabsorbed overhead due the contractor.

Proof of actual unabsorbed overhead requires the making of estimates in steps 1 and 2. Estimates are a legitimate means of proving damages and are frequently used in pricing adjustments.³³⁰

The amount by which a contractor's distribution base was reduced by delay can be estimated by comparing work performed during the delay to work the contractor had scheduled for

performance prior to the delay. The reasonableness of the contractor's schedule can be determined by comparing actual performance to scheduled performance in periods before and after the delay. Factors such as weather, the nature of the contract, and the unique circumstances of the contractor also can be considered in determining how much the delay reduced the contractor's distribution base.

Because a contractor's actual distribution base is the point of focus, rather than contract billings, the cause and effect relationship between delay and unabsorbed overhead is clearer enabling the parties to tailor recovery to the actual circumstances.

(ii) Extended Overhead. Entitlement to extended overhead has not yet been authoritatively decided.³³¹ If, however, a court or board were to find that a contractor was entitled to an adjustment based on increased administration in the absence of increased cost, the amount of the equitable adjustment could be determined based on the actual value³³² of the additional administrative services.

First, determine what additional administrative services were required--what extra reports the contractor provided, what additional time was spent on contract by home office personnel. Second, determine the value of those services based on what the reasonable cost of providing those services

would be.³³³ The amount of the equitable adjustment would be the value of the additional administrative services less an adjustment to prevent double recovery of indirect costs.³³⁴

3. Getting the Boards and Courts to Accept Alternatives to Eichleay

a. Overcoming Capital Electric and Savoy Construction

After the Court of Appeals for the Federal Circuit's decision in *Capital Electric*³³⁵ and *Savoy Construction*,³³⁶ boards and courts understandably have been reluctant to find the *Eichleay* formula an improper method for measuring unabsorbed overhead. The author believes this reluctance will continue. However, these two opinions should not be interpreted as an unqualified endorsement of the *Eichleay* formula by the Federal Circuit.³³⁷ First, the Court did not support its decision in *Capital Electric* with analysis of why the *Eichleay* formula properly compensated the contractor. Instead, the Court based its decision upon the formula's long history of use, stating that overruling such long standing precedent was an action more appropriate for Congress.³³⁸ Likewise, *Savoy Construction* contained no analysis of why the *Eichleay* formula properly compensated the contractor.³³⁹ Second, while the Government argued in *Capital Electric* that the *Eichleay* formula improperly measured the contractor's increased costs, the Government did not provide an acceptable

alternative. The Government merely offered another formula which the Federal Circuit found equally imprecise.³⁴⁰ Third, neither case showed that the *Eichleay* formula clearly over compensated the contractor.

Clear proof of over compensation can be presented in two ways: (1) by estimating the actual effect of the delay on the contractor's distribution base,³⁴¹ or (2) by comparing the facts of a particular case with the presumptions of the *Eichleay* formula.³⁴² The presumptions that do not fit represent areas of over compensation. As the DOT CAB stated in *G.S. and L. Mechanical and Construction*:

[The goal of any formula] is to provide compensation to a contractor which is reasonably equal to the proportion of actual total overhead costs . . . allocable to [its] contract. . . . However, if any formula departs from this goal when applied to a specific set of circumstances, then however acceptable it may have been in other cases, it is not appropriate for use when those specific circumstances exist.³⁴³

Thus, a board or court, recognizing in a particular case that one of the presumptions upon which the *Eichleay* formula rests is invalid, may without overruling precedent choose not to use the *Eichleay* formula. Similarly, a board or court legitimately may reduce the amount recoverable under the *Eichleay* formula to offset any over compensation that might otherwise occur. This approach was used in *Excavation-Construction* where the Board limited the contractor to 80% of

the per diem rate because the contractor's books were unavailable for audit.³⁴⁴

Had the Federal Circuit faced a case clearly showing over compensation under the *Eichleay* formula or providing a more appropriate method of computing unabsorbed overhead it is possible that it would have considered the issue *en banc* on appeal and reached a different result.³⁴⁵ Precedent does not mandate use of the *Eichleay* formula. On reconsideration of the original *Eichleay* decision, the ASBCA stated:

There is no set formula for the determination of [unabsorbed overhead]. In the instant case we were persuaded that of the two methods advanced to us the appellant's method produced an equitable adjustment and that the Government's did not. The method to be used in future cases will depend upon the record made in those cases.³⁴⁶

However, the frequency with which the *Eichleay* formula has been used since the original *Eichleay* decision creates almost a presumption that its use will provide an equitable recovery. Therefore, the Government can expect to bear the burden of proving that any alternate method of recovery will better approximate unabsorbed overhead than the *Eichleay* formula.³⁴⁷ Nonetheless the issue is whether the *Eichleay* formula reasonably measures unabsorbed overhead.³⁴⁸ Recent changes to the FAR state that "no presumption of reasonableness shall be attached to the incurrence of costs by a contractor" and upon challenge "the burden of proof

shall be upon the contractor to establish that such cost is reasonable."³⁴⁹ Thus, for contracts made after the effective date of the FAR change, the burden of proving that the *Eichleay* formula provides a reasonable measure of cost arguably rests with the contractor.

b. Contractually Establishing the Method of Recovering Unabsorbed Overhead

The Government, if it chooses to eliminate the *Eichleay* formula as a measure of unabsorbed and/or extended overhead, can do so without the Federal Circuit overruling *Capital Electric* and without Congressional action. The Government, working together with the contracting community, can develop an approach for compensating delayed contractors that is equitable to both parties and can incorporate such an approach into the procurement regulations.³⁵⁰ In addition, the Government has the option of unilaterally developing a contract clause prescribing how unabsorbed overhead and/or extended overhead damages are to be measured. A contract clause could be drafted to require a contractor to prove the actual amount by which its distribution base was reduced as a result of Government-caused delay. Such a clause might read:

Any claim for recovery of unabsorbed/extended overhead will be determined based on the actual amount by which the contractor's distribution base is reduced as a result of Government caused delay. Formulas such as

Eichleay and modifications thereof are not acceptable measures of unabsorbed overhead and therefore will not be used for this purpose.

As Chapter 2 explained the GSA, the VA, and the Postal Service, insert in their construction contracts a clause limiting overhead to 10% of the direct costs of a change.³⁵¹ These clauses have successfully limited claims for unabsorbed and extended overhead.³⁵² Moreover, the Court of Appeals for the Federal Circuit recently upheld their enforceability.³⁵³

Some Government agencies may not want to adopt a clause that limits a contractor's total overhead recovery to 10% of the direct costs of a change³⁵⁴ but may want to limit the amount of unabsorbed overhead that can be claimed as a result of delay. Development of a contract clause limiting unabsorbed overhead to 10% of the total contract price should prevent recovery of unabsorbed overhead in amounts disproportionate to the total contract price.

4. Preventing Double Recovery

a. Percentage Markup on Direct Costs

Double recovery of indirect costs becomes an issue when a contractor, having already received a percentage markup³⁵⁵ on the increased direct costs of a change or delay, seeks to recover unabsorbed overhead. Does receipt of both a

percentage markup on direct costs incurred during the delay and unabsorbed overhead, in fact, constitute double recovery? In almost all cases where this issue has been raised, the percentage markup on direct costs has been either denied or subtracted from the contractor's recovery of unabsorbed overhead.³⁵⁶

Whether or not receipt of both unabsorbed overhead and a percentage markup on the increased direct costs of a change or delay constitutes double recovery depends upon the method used to determine unabsorbed overhead. Some methods of computing unabsorbed overhead credit the Government with the value of any additional work performed by the contractor during the delay.³⁵⁷ When such a method is used, recovery of both unabsorbed overhead and a percentage markup on direct costs does not constitute double recovery. However, a per diem formula such as *Eichleay* inadequately allows for substituted work performed during the delay period.³⁵⁸ Thus, when the *Eichleay* formula is used the contractor should be limited to recovery under the *Eichleay* formula or the percentage markup on direct costs, but not both.

To date, boards and courts have credited delayed contracts with only the percentage markup paid to the contractor on change orders for work performed during the delay period. Delayed contracts have not been credited with the amount of fixed indirect cost allocable to all substitute work

performed during the delay; specifically, the delayed contract is not credited with work made possible by the delay but performed on other contracts. Were it not for the delay, the direct costs of this substituted work would not have been generated. Failure to credit the delayed contract with the fixed indirect costs absorbed by substituted work of whatever type compensates the contractor for a loss that never occurred.

When boards and courts subtract from the *Eichleay* computation the percentage markup paid to the contractor on change orders for work performed during the delay period, they erroneously deduct the entire percentage markup. They fail to recognize that the percentage markup may include both fixed and variable elements of indirect cost.³⁵⁹ Unlike unabsorbed overhead,³⁶⁰ the percentage markup on direct costs is intended to compensate the contractor for its fixed and variable indirect costs and for this reason includes elements of both. Deduction of the total percentage markup results in the contractor receiving nothing for variable indirect costs incurred on work performed during the delay period.

b. Direct Recovery of Normally Fixed Indirect Costs

Receipt of unabsorbed overhead fully compensates a contractor for all fixed indirect costs incurred during the delay period. Direct recovery of fixed indirect costs incurred

during the delay period and unabsorbed overhead constitutes double recovery.³⁶¹ Only in the most unusual circumstances would both direct recovery of a normally fixed indirect cost and unabsorbed overhead be proper.

D. Unabsorbed Overhead in the Context of a Termination for Convenience

Unabsorbed overhead in the context of a termination for convenience is discussed in Chapter 4.³⁶² Three areas are examined: pre-termination unabsorbed overhead, post-termination unabsorbed overhead, and unabsorbed overhead when a contract is partially terminated for convenience.

CHAPTER 4
TERMINATIONS FOR CONVENIENCE

I. TERMINATION SETTLEMENTS

A. Objective

The objective of a termination settlement is to compensate the contractor fairly for the work performed and the preparations made for the terminated portions of the contract³⁶³ and to reimburse the contractor for its reasonable costs of settling the terminated work.³⁶⁴ If possible, the parties should negotiate a settlement agreement accomplishing these goals.³⁶⁵ If an agreement cannot be reached, then the contracting officer will unilaterally determine fair compensation.³⁶⁶ The contracting officer's determination is a final decision from which the contractor may appeal under the Disputes clause.³⁶⁷

Cost is the dominant factor in determining fair compensation. A contractor's costs of performing and preparing to perform the terminated work are the basis of a termination settlement. Exact measurement of cost is not, however, a prerequisite to recovery. Fair compensation is a matter of judgment and cannot be measured exactly.³⁶⁸

This goal of fair compensation plays an important role in recovery of indirect costs. Boards and courts deviate from strict accounting principles,³⁶⁹ use jury verdicts, and accept less precise measures of cost when necessary to assure fair compensation. They are more willing to risk overpayment when a contract is terminated for convenience than at other times.

B. Complex Nature of Termination Settlements

A termination for convenience is a complex pricing action for a number of reasons. First there are a number of costs involved: pre-termination costs, continuing costs, and settlement costs. Second, few accounting systems are designed to measure cost at various stages of contract completion. Thus, there are problems of proof. Third, termination affects the ability of direct cost to serve as a distribution base. Little direct cost is generated in the early stages of contract performance; in contrast indirect effort may be substantial. Similarly, the contractor's settlement effort generates little, if any, direct cost but requires substantial indirect effort.

Contracts partially terminated for convenience present an additional challenge in that costs of the terminated and unterminated portions of the contract must be segregated. Furthermore, the unterminated portion of the contract may

cost more to perform as a result of the partial termination and require repricing (a cost measurement problem).

Some of the more challenging issues addressed in this chapter are:

- (1) How to fairly compensate a contractor in the absence of adequate accounting records.
- (2) Which normally indirect costs can be charged directly to the terminated contract and which cannot.
- (3) What adjustments to a contractor's indirect cost groupings are necessary to prevent double recovery when costs normally treated as indirect costs are charged directly to the terminated contract.
- (4) Whether normally indirect costs, charged directly to the terminated contract, should be allocated a share of an indirect cost grouping of which, but for the termination settlement, they would be a part.

The answers are often fact specific and depend in part on the category of termination cost involved. The specific categories of termination cost are discussed separately in paragraphs II through IV below. Post termination unabsorbed overhead is discussed in paragraph V and partial terminations for convenience in paragraph VI.

II. INDIRECT COSTS OF PERFORMING AND PREPARING TO PERFORM THE TERMINATED CONTRACT

A. Indirect Cost Rates

Indirect costs of performing and preparing to perform the terminated work are recovered, for the most part, in the same manner as if the contract had proceeded to completion. The contractor's normal indirect cost rate is multiplied by the direct costs incurred in preparing to perform and in performing the terminated contract to obtain recoverable indirect costs.³⁷⁰ In most instances, the contractor's actual rather than projected indirect cost rate is used.³⁷¹ This is because termination settlements normally are priced at a time when actual indirect cost rates are known.³⁷²

The choice of base period can significantly affect indirect cost rates and the amount of indirect cost allocated to the terminated contract.³⁷³ Normally, the contractor selects as its base period its normal annual accounting period or the period of contract performance.³⁷⁴ The Government will contest the contractor's choice of a base period if it fails to include or does not closely conform to the period of contract preparation and performance.³⁷⁵

B. Direct Charging of Costs Normally Treated as Indirect Costs

When a contract is terminated before completion, a contractor's established procedures for allocating indirect costs,³⁷⁶ in many instances, do not equitably measure the indirect costs of the terminated contract. The reason is that contractors often incur a significant amount of nonrecurring indirect costs at the beginning of contract performance, a time when direct costs--the normal distribution base--are low.³⁷⁷ When a contractor's normal method of allocating indirect costs fails to equitably compensate the contractor for its indirect costs of performing the terminated contract, a departure from its normal practice is proper.³⁷⁸ In most instances, the contractor continues to use its direct cost distribution base but charges certain normally indirect costs directly to the terminated contract.

1. Indirect Costs Specifically Permitted as Direct Costs

The FAR specifically permits contractors to charge directly to the terminated contract initial costs including starting load and preparatory costs.³⁷⁹ Starting load costs are nonrecurring labor, material, and related overhead costs incurred in the early part of production.³⁸⁰ Starting load

costs result from factors such as: "(i) [e]xcessive spoilage due to inexperienced labor; (ii) [i]dle time and subnormal production due to testing and changing production methods; (iii) [t]raining; and (iv) [l]ack of familiarity or experience with the product, materials, or manufacturing processes."³⁸¹ Preparatory costs are costs incurred in preparing to perform the terminated contract.³⁸² They include such costs as "those incurred for initial plant rearrangement and alterations, management and personnel organization, and production planning."³⁸³ When initial costs are charged as direct costs, FAR 31.205-42(c)(2) specifically prohibits their inclusion in overhead but is silent as to whether initial costs of other contracts must be excluded from indirect cost pools prior to their allocation to the terminated contract.

While the FAR specifically permits initial costs to be recovered as direct costs it does not require direct recovery. To recover initial costs directly the contractor will have to specifically identify these costs to the contract and show that they have not already been recovered through inclusion in indirect cost groupings.³⁸⁴

2. Indirect Costs Not Specifically Permitted as Direct Costs

A substantial number of cases have permitted direct charging of pre-termination indirect costs that FAR does not specifically allow as direct costs.³⁸⁵ The ASBCA stated in *Switlik Parachute Company*:³⁸⁶

There is nothing objectionable about charging any cost directly, provided it is properly allocable to the contract, and other costs of the same character are excluded from indirect cost pools charged to the contract, in order to avoid 'double screening' or duplicate charging. In particular, in a termination for convenience situation, it is common to remove some or all types of indirect costs from overhead or G&A and to charge them directly in order to achieve equitable allocation.

Direct charging of indirect costs other than those specifically permitted to be charged directly is often denied.³⁸⁷ Refusal usually results when (1) the board finds the contractor's normal method of recovering indirect costs has fully compensated contractor for the costs incurred--allowance would constitute double counting, or (2) the contractor fails to prove that costs charged directly were incurred specifically for the terminated contract.³⁸⁸

3. Consistency Issues Raised by Direct Charging of Normally Indirect Costs

Direct charging of indirect pre-termination costs raises a number of questions:

- (1) Whether direct charging is permissible under the Cost Principles and CAS?³⁸⁹
- (2) What must be done to prevent double recovery? That is, what adjustments to the indirect cost grouping are necessary to ensure that the contractor does not recover the cost both as a direct cost and as an indirect cost.
- (3) Whether the normally indirect pre-termination cost should itself be burdened with indirect costs.

These questions are discussed below.³⁹⁰

a. Is Direct Charging of Indirect Pre-termination Costs Permissible Under the Cost Principles and the CAS?

Under the Cost Principles and CAS 402, "[n]o final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other cost objective."³⁹¹ The question is whether a termination for convenience is a change

in circumstance sufficient to allow direct charging of a cost normally charged indirectly.

Obviously, the fact of termination does not change the circumstances under which a cost **was incurred**. What changes is the contractor's method of recovering its costs; the circumstances of recovery--not of incurrence--change. Does a change in the circumstances of recovery, one making recovery under the contractor's established method of distributing indirect costs inequitable, permit direct recovery of normally indirect costs? Literally read, the Cost Principles and CAS allow direct charging of costs normally charged indirectly **only** when the circumstances of incurrence differ from those of other costs incurred for the same purpose charged indirectly.

The FAR specifically allows direct recovery of initial indirect costs but does not address the consistency issue with respect to their direct charging except to require that initial costs claimed directly not be included in overhead.³⁹² Nor have the boards and courts reconciled the consistency requirements of CAS 402 and the Cost Principles with direct charging of pre-termination indirect costs.³⁹³ Consistency, when raised is discussed in terms of double charging.

Without exception, the commentators believe that some direct charging of indirect costs is necessary and permissible in the context of a termination for convenience;³⁹⁴ however, they differ on how to reconcile direct charging with the CAS and Cost Principles' requirement for consistency. Several commentators contend that pre-termination indirect costs are not "costs incurred for the same purpose in like circumstances" as the indirect costs of other cost objectives.³⁹⁵ In contrast, Bedingfield and Rosen view direct charging of pre-termination indirect costs as a voluntary change in accounting practice, a one-time special allocation of indirect costs.³⁹⁶

Bedingfield's and Rosen's view of direct charging as a one-time voluntary change in accounting practice is the better view. A prerequisite to making any change in accounting practice is proof that the established accounting practice is inequitable.³⁹⁷ When such proof is not present direct charging of pre-termination indirect costs should not be permitted. The mere fact that a contract has been terminated for convenience is not sufficient reason to allow a contractor, on a selective basis, to charge normally indirect costs directly to the terminated contract.³⁹⁸ The "voluntary change" approach is consistent with CAS 402 and the Cost Principles requirements for consistency.³⁹⁹ It is also consistent with FAR 31.205-42(c) which specifically allows certain initial costs to be charged directly. FAR 31.205-

42(c), itself, limits direct recovery of initial costs to those instances where recovery under the contractor's established accounting practices is inequitable.⁴⁰⁰

The Cost Accounting Standards clause and the Disclosure and Consistency of Accounting clause seemingly would preclude retroactive application of any change in accounting practice including a voluntary change for CAS-covered and modified CAS-covered contracts.⁴⁰¹ Nonetheless, it appears unlikely that either of these clauses would prevent retroactive application of a change in accounting practice necessary to equitably distribute costs for purposes of a termination for convenience.⁴⁰²

b. Preventing Double Recovery

When a normally indirect cost is charged directly to a terminated contract the direct charge must be removed from the contractor's indirect cost pool before the pool is distributed to the terminated contract to avoid over recovery.⁴⁰³ The difficult question is what other costs, if any, should be removed from the contractor's indirect cost pool.

CAS 402 and FAR 31.203(a) state that indirect costs "shall not be allocated to a final cost objective if other costs incurred for the same purpose in like circumstances have been

included as a direct cost of that or any other final cost objective."⁴⁰⁴ Therefore, if costs remaining in the indirect cost pool are costs "incurred for the same purpose in like circumstances" as costs charged directly to the contract they must be removed from the indirect cost pool. Several commentators argue that removal is unnecessary in that the termination is a change in circumstance--that other costs in the indirect cost grouping are not "costs incurred for the same purpose in like circumstances" within the meaning of CAS 402 and the Cost Principles.⁴⁰⁵

Regardless of how the circumstances are characterized, failure to remove other costs incurred for the same purpose from an indirect cost grouping prior to its distribution to the terminated contract results in overcharging the terminated contract. For purposes of illustration, assume a contractor charges initial costs directly to the terminated contract and removes the direct charge from its indirect cost pool. Failure to remove the initial costs of other contracts from the indirect cost pool results in the terminated contract bearing all of its initial costs in the form of a direct charge and through allocation from the indirect cost pool a portion of the initial costs of other cost objectives.⁴⁰⁶ Therefore, when a pre-termination cost is removed from an indirect cost grouping and charged directly to a terminated contract, indirect costs incurred for the same purpose for other cost objectives should be removed from

the indirect cost grouping before distribution is made to the terminated contract.

Settlement costs are also charged directly to terminated contracts. Clearly to avoid double recovery, a contractor must remove settlement costs charged directly to the terminated contract from indirect cost groupings prior to distribution to the pre-termination effort.⁴⁰⁷ The real issue is whether a contractor must remove indirect costs incurred for the same purpose as settlement costs from an indirect cost grouping prior to distribution to the pre-termination effort? The answer is no. Settlement costs are incurred in different circumstances than nonsettlement costs.⁴⁰⁸ Thus, when settlement costs, such as attorneys fees, are charged directly to a terminated contract, a contractor is not required to remove non-settlement attorneys fees from indirect cost groupings prior to distribution to the terminated contract.⁴⁰⁹

c. Whether Costs Normally Charged Indirectly Should Be Burdened with Indirect Costs

Direct cost is commonly used as a distribution base because it provides an approximate measure of the relative benefits received by the several cost objectives from an indirect cost grouping.⁴¹⁰ When direct cost does not closely approximate the relative benefits received by the several cost objectives

it is not used as a distribution base (i.e., burdened with indirect costs).⁴¹¹ Thus, when indirect costs are treated as direct costs for purposes of a termination settlement, whether or not these new direct costs should be burdened with indirect costs (added to the distribution base) depends upon whether their incurrence marks an increase in benefits received from the indirect cost pool. In most instances, their direct charging does not mark such an increase. Common sense dictates that direct charging of an indirect cost signifies, if anything, that the terminated contract benefits less from the costs remaining in the indirect cost grouping than it did prior to the direct charging.

Boards and courts usually do not allow contractors to recover indirect costs on costs that would be classified as indirect but for the termination.⁴¹² They reason that one cannot charge overhead on overhead.⁴¹³ In effect, they characterize the direct charge as an element of overhead or an indirect cost even though it is charged directly.

C. Subcontractor Claims

The FAR provides the following guidance on burdening subcontractor claims with indirect costs:

An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors; provided, that the amount allocated is reasonably proportionate to the relative benefits received The indirect expense so

allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.⁴¹⁴

Generally, this means that settlements with subcontractors cannot be burdened with factory indirect costs (because the subcontract effort did not benefit from such costs) but can be burdened with G&A.⁴¹⁵ G&A on subcontractor settlements may be allowed even when the Government settles directly with the subcontractor.⁴¹⁶

Receipt of G&A on subcontractor settlements is not automatic. For example, in *Sunstrand Turbo v. United States* the contractor was not allowed to burden the settlement value of terminated fixed price subcontracts with G&A.⁴¹⁷ The ASBCA, in an earlier opinion, found no evidence that the contractor had failed to recover all the pre-termination G&A it had incurred through application of its G&A rate to other work.⁴¹⁸ The ASBCA's decision was influenced by the fact that the contractor's other work during the pre-termination period included a substantial number of cost plus fixed fee Government contracts.⁴¹⁹ The Court upheld the Board because the contractor was unable to establish that the record did not support the Board's finding.

In *Worsham Construction Co.*,⁴²⁰ the contractor was permitted to recover home office overhead (G&A) at 50% of its standard home office overhead rate. Although it was the contractor's

normal practice to include subcontract costs in its direct cost base, the contractor did not prove what relationship existed between subcontract costs and the incurrence of home office overhead. Thus, the Board did not allow the full overhead rate to be applied.

D. Unabsorbed Overhead

Unabsorbed overhead occurring before termination is recoverable under the Termination for Convenience clause.⁴²¹ Termination of a contract complicates recovery of pre-termination unabsorbed overhead. For example, it raises questions as to which costs should be included in *Eichleay* formula "billings."⁴²² In addition, termination, as discussed below, may allow contractors to recover unabsorbed overhead when delay is contractor caused. Excepting these differences, quantum and entitlement are determined in the same manner whether a contract proceeds to completion or is terminated for convenience.⁴²³

When a contract is terminated for convenience, unabsorbed overhead is normally recovered under the Termination for Convenience clause rather than another contract clause.⁴²⁴ The Termination for Convenience clause may permit a contractor to recover unabsorbed overhead where it would not be so entitled had the contract proceeded to completion. Specifically, a contractor may be entitled to pre-termination

unabsorbed overhead where delay is contractor caused.⁴²⁵ In *Worsham Construction Co.*, the ASBCA stated:

The parties are simply arguing the unabsorbed overhead issue as if an equitable adjustment under a firm-fixed-price contract is involved. The Government assumes, that if the claimed event would not be compensable if the termination had not occurred, costs attributable to that claim event also are not recoverable as part of the termination settlement. This basic assumption underlying the Government position is erroneous. Even assuming that the delayed performance of the contract was caused in part by appellant under the controlling TFC clause the contractor is entitled to recover all allowable costs.⁴²⁶

A recent Claims Court decision, *Penberthy Electromelt Int'l v. United States*⁴²⁷ casts doubt on the extent to which *Worsham Construction Co.* will be followed by other boards and courts. In *Penberthy* the Court held that "[f]or plaintiff to recover, it must show that it. . . incurred reasonable and unavoidable costs because of defendant's improper delay in either finally terminating the contract, or giving notice to proceed with the work. . . Plaintiff cannot meet this test [because] the delay, at least initially, was caused by plaintiff."⁴²⁸ However, the Court did not refer to *Worsham Construction Co.*, decided the previous year; apparently the case was not brought to its attention. The Court failed to distinguish between recovery of delay damages under a completed contract and recovery of delay damages under a contract terminated for convenience; the issue simply was not addressed.

E. Accounting Records

It is often said that a termination for convenience turns a fixed price contract into a cost reimbursement contract.⁴²⁹ There is, however, a substantial difference between a fixed price contract terminated for convenience and a cost reimbursement contract--the availability of records from which cost can be determined.⁴³⁰

Cost accounting systems are designed to provide data for specific, regularly occurring events.⁴³¹ A termination for convenience is an unusual event in that contracts normally proceed to completion.⁴³² For this reason, an accounting system "adequate for allocating costs to final cost objectives should all final cost objectives be completed may be inadequate when terminations occur."⁴³³

When a contract is terminated for convenience one needs an accounting system capable of measuring costs at varying stages of contract completion. Unfortunately, only very sophisticated cost accounting systems have this capacity, and such systems are expensive to establish and maintain. Because of the cost, few contractors performing fixed price contracts have a cost accounting system capable of measuring cost at varying stages of contract completion.⁴³⁴

While the FAR specifically states that contractors are not required to maintain "unduly elaborate" cost accounting systems for the purposes of measuring costs should the contract be terminated for convenience,⁴³⁵ a contractor has the burden of proof with respect to termination costs⁴³⁶ and its settlement proposal must be supported in reasonable detail by adequate accounting data.⁴³⁷ Meeting this burden of proof in the absence of a cost accounting system capable of measuring cost at various stages of contract completion presents problems.⁴³⁸ The FAR has attempted to ameliorate these problems by allowing contractors to estimate costs⁴³⁹ and to use total cost as a basis for recovery.⁴⁴⁰ Normally, contractors will be compensated for their indirect costs whenever a reasonable basis for measurement exists⁴⁴¹... particularly for indirect costs incurred before termination.⁴⁴² Nonetheless, the absence of adequate cost records may prevent a contractor from recovering indirect costs or reduce its recovery.⁴⁴³

F. Cost Principles

The cases indicate that allowability of cost becomes a significant issue when a contract is terminated for convenience.⁴⁴⁴ The Government closely examines costs included in indirect costs pools and is quick to question their allowability even when the settlement amount claimed is small.⁴⁴⁵ With this in mind, it is important to note that

the Cost Principles may have less effect in determining allowability when a contract is terminated for convenience than at other times.

Although Termination for Convenience clauses state that the Cost Principles shall be used as the basis for proposing, negotiating, and determining costs under terminated contracts,⁴⁴⁶ the exact role of the Cost Principles is unclear.⁴⁴⁷ The Cost Principles are not applied to terminations for convenience with the same rigor as they are to other pricing actions.⁴⁴⁸ Strict application of the Cost Principles would make unallowable certain costs which a contractor may have included in its fixed-price bid.⁴⁴⁹

The FAR supports the position that the Cost Principles need not be strictly applied: "The cost principles . . . shall, subject to the general principles in 49.201, . . . be used in asserting, negotiating, or determining costs relevant to termination settlements."⁴⁵⁰ The general principles of FAR 49.201 stress fairness and judgment over strict accounting rules in determining the amount of a termination settlement.⁴⁵¹ Thus, a number of cases have adopted the view that the Cost Principles need not be strictly applied to terminations for convenience.⁴⁵² Nonetheless, it appears the exception rather than the rule when a board or court decides that application of the Cost Principles would result in a contractor being compensated unfairly.⁴⁵³

G. General Limits on Recovery of Indirect Costs

The FAR places a ceiling on recovery of termination costs.⁴⁵⁴ The total amount payable (excluding settlement costs) to a contractor with a fixed-price contract is the contract price less payments made under the contract.⁴⁵⁵ While this is a general cost limitation, the ceiling may prevent recovery of indirect costs to which a contractor would otherwise be entitled. A contractor that cannot recover all of its costs due to this general cost ceiling should ensure that:

(1) An unpriced constructive change⁴⁵⁶ or differing site condition⁴⁵⁷ is not the reason that costs exceed contract price. Either would entitle a contractor to an equitable adjustment and a corresponding increase in the cost ceiling.

(2) All direct and indirect costs, properly characterized as settlement costs, are claimed as settlement costs rather than as costs of performance.⁴⁵⁸

Because they are not costs of "performing" the terminated work, settlement costs are not subject to the price ceiling.⁴⁵⁹

III. CONTINUING COSTS

The FAR makes continuing costs allowable, stating: "Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable."⁴⁶⁰ Continuing costs include salaries and other direct costs incurred after termination related to de-activation of personnel,⁴⁶¹ severance pay,⁴⁶² work in progress,⁴⁶³ continuing facilities and equipment costs,⁴⁶⁴ mitigation costs,⁴⁶⁵ and post-termination unabsorbed overhead.⁴⁶⁶

Costs normally included in overhead can qualify as continuing costs and be recovered directly.⁴⁶⁷ Continuing costs, to the extent they are incurred in performance of a direct cost function, can be burdened with indirect costs. For example, completion of work in progress is a direct cost function that should be burdened with indirect costs. Severance pay, on the other hand, is not a direct cost function and accordingly should not bear any indirect costs.⁴⁶⁸

IV. SETTLEMENT COSTS

A contractor whose contract is terminated for convenience has a number of duties imposed upon it by the Termination for Convenience clause.⁴⁶⁹ These duties include preparing and presenting a termination settlement to the contracting

officer; terminating and settling subcontractor claims; and storing, transporting, protecting and disposing of termination inventory.⁴⁷⁰ Settlement costs are not subject to the price ceiling.⁴⁷¹ Contractors are entitled to full reimbursement for the costs of settling a contract. An exception is made when the contract contains a "short-form" termination for convenience clause.⁴⁷² Contractors are not entitled to profit on settlement costs.⁴⁷³

A. Direct Recovery of Normally Indirect Costs

Settlement actions often involve labor for storage, transportation, protection, and disposal of termination inventory, considerable administrative effort, executive time, and legal and accounting effort--all of which are normally indirect charges.⁴⁷⁴ Despite their normally indirect nature, these costs usually are charged directly to the terminated contract.⁴⁷⁵

As a prerequisite to direct charging a contractor must present proof that the settlement costs were excluded from its indirect cost groupings.⁴⁷⁶ When settlement costs are treated as indirect costs when incurred, their subsequent removal from indirect cost groupings may be too late to prevent over recovery and thus may preclude direct charging.⁴⁷⁷ The burden of proving that direct charging will not result in double recovery (that the cost was removed from

the indirect cost grouping prior to allocation) lies with the contractor.⁴⁷⁸

Under the FAR, a contractor is limited in its ability to burden settlement costs.⁴⁷⁹ Usually, the only burden that can be placed on settlement costs is payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs related to salary and wages incurred as settlement expenses.⁴⁸⁰

The probable reason for the FAR's limiting the burden on direct settlement costs is:

- (1) Potential double recovery;⁴⁸¹
- (2) Perception that settlement costs are easily identified and capable of being charged directly;⁴⁸² and
- (3) The settlement action usually benefits differently than other cost objectives from the incurrence of indirect costs.⁴⁸³

Because the ability to burden settlement costs is limited and because profit is not allowable on settlement costs, contractors should not claim costs properly recoverable as pre-termination or continuing costs as settlement costs.

The limitation imposed by FAR 31.205-42(g)(iii) on the burdening of settlement costs is not absolute. The

limitation is prefaced by the word "normally" indicating that it may not apply in all circumstances.⁴⁸⁴ In numerous cases, boards have not limited the burden on settlement costs.⁴⁸⁵ Generally, the nature of the settlement cost determines whether or not the limitation will apply.⁴⁸⁶ Normally, boards refuse to apply the limitation to settlement work of direct labor employees but will not hesitate to limit or disallow additional burden on indirect costs reclassified as direct for purposes of settlement.⁴⁸⁷

Bedingfield and Rosen suggest several alternatives to direct charging that contractors can use to recover indirect settlement costs other than those related to salaries and wages incurred as settlement expenses.⁴⁸⁸ First, they suggest negotiating a "special indirect cost allocation in the nature of the one-time allocation authorized under 4 CFR 410.50(j)."⁴⁸⁹ In the alternative, they suggest a reconstitution of existing indirect cost pools so as to allocate to the terminated contract only those indirect expenses which provided services to settlement action.

B. Burden of Proof

A contractor bears the burden of proving settlement costs.⁴⁹⁰ The lenient attitude that exists with respect to proof of pre-termination performance costs may not carry over into the settlement area. Termination serves as notice to a

contractor that any future costs incurred for the terminated contract must be recovered on what is, in effect, a cost basis and that proof of their incurrence will be a prerequisite to recovery. One would, therefore, expect more record keeping.

To ensure full recovery, contractors would be well advised to present accounting records detailing their actual costs.⁴⁹¹ Detailed accounting records cannot be developed after the fact. To present detailed accounting records, most contractors will have to modify their accounting systems upon receipt of notice of termination.⁴⁹² In the absence of detailed accounting records, contemporaneous written documentation will aid recovery.⁴⁹³ If settlement expenses are expected to be significant contractors should obtain expert accounting advice.

In order to obtain detailed cost data to substantiate the direct charging of settlement costs⁴⁹⁴ indirect costs must be segregated and specifically identified to the settlement action. In most instances, this is a three-step process. First, the contractor's accounting system is modified by establishing a separate cost account to specifically identify and accumulate settlement costs.⁴⁹⁵ Second, steps must be taken to prevent double charging--to ensure that costs claimed directly as settlement costs are removed from indirect cost pools and that proof of their removal is

available for audit review.⁴⁹⁶ Finally, to ensure that all indirect settlement costs are identified for direct charging, contractor personnel at all levels must keep time records supporting their settlement efforts. Because persons performing settlement work are usually people who do not keep time records in the course of their normal duties some training and behavioral modification is necessary.⁴⁹⁷

C. Types of Settlement Costs

The FAR lists three categories of settlement costs, costs of: (1) preparing and presenting the termination settlement, (2) settling subcontractor claims; and (3) safeguarding, inventorying, and disposing of terminated inventory and special equipment.⁴⁹⁸ Because settlement costs generally would be charged indirectly but for the termination, selected issues involving their recovery are discussed briefly below.

1. Costs of Preparing and Presenting a Termination Settlement

The costs of preparing and presenting a termination settlement typically include the salaries of the contractor's administrative staff and executive personnel, legal fees, accounting services, and the service of experts. Surprisingly, these costs are the subject of frequent litigation. The areas of contest are (1) adequacy of the

contractor's proof that it incurred such costs,⁴⁹⁹ (2) reasonableness of the claimed costs, and (3) whether such costs were in fact incurred in the preparation and presentation of the termination settlement rather than in the prosecution of a claim against the Government.

a. Reasonableness

To be allowable, a cost must be reasonable both in nature and amount. The Government closely reviews settlement costs and frequently challenges the reasonableness of (1) attorney's fees,⁵⁰⁰ (2) use of outside experts,⁵⁰¹ (3) the number of hours expended by the contractor in preparing and presenting its termination settlement,⁵⁰² and (4) having professional personnel do clerical work.⁵⁰³ Reasonableness is determined by analysis of the individual costs claimed and not by how large settlement expenses are in proportion to the total amount claimed.⁵⁰⁴

b. Proving that Costs Claimed Were Not Costs of Making a Claim Against the Government

Unlike costs of preparing and presenting a settlement proposal to the contracting officer, costs of making a claim against the Government (appealing a contracting officer's final decision) are not allowable.⁵⁰⁵ The Government will challenge costs of contesting a termination for default

(whether or not successful) and of contesting the contracting officer's final decision as to the amount of the termination settlement. To avoid dispute and ensure recovery of allowable costs, contractors should treat the costs of preparing and presenting a termination settlement proposal to the contracting officer and the costs of challenging the contracting officer's final decision as separate cost objectives.⁵⁰⁶ Furthermore, contractors must be prepared to explain why certain costs were charged as costs of preparing and presenting the termination settlement rather than as costs of making a claim against the Government.⁵⁰⁷

Challenging a contracting officer's final decision as to a default termination or the amount of a termination settlement can be expensive and, as indicated above, is not reimbursable. Whenever possible contractors naturally try to characterize such costs as costs of preparing and presenting a settlement proposal to the contracting officer rather than as costs of making a claim against the Government. Generally, the boards of contract appeals have allowed such characterization whenever a reasonable relationship to the settlement proposal is proven.⁵⁰⁸

2. Costs of Safeguarding, Inventorying, and Disposing of Terminated Inventory

The costs of safeguarding, inventorying and disposing of inventory are costs normally included in overhead.⁵⁰⁹ However, they are recovered as direct costs when incurred for terminated inventory.⁵¹⁰ Attempts by contractors to recover such costs through markups on the terminated inventory are usually unsuccessful. For example, in *Essex Electro Engineers*, the contractor unsuccessfully attempted to recover costs of handling, restocking, and cancelling orders by adding its normal overhead markup to the purchase price of the cancelled and returned material.⁵¹¹ Because it was improper under the procurement regulations to include the cost of cancelled and returned materials in the settlement proposal the Board found it improper to include a markup on such materials.⁵¹² The Board noted that it was not the contractor's usual accounting practice to add overhead on items cancelled or returned to the vendor.⁵¹³ Absent proof that the cancelled or returned materials generated the same material handling costs as did materials used in manufacturing and incorporated into the final product they cannot be burdened with the contractor's standard markup for material handling.⁵¹⁴

V. UNABSORBED OVERHEAD AFTER TERMINATION FOR CONVENIENCE

When a contract is terminated for convenience, performance on the terminated portion of the contract normally stops. Despite work stoppage, the contractor's fixed indirect costs continue. Indirect costs that would have been charged to the terminated portion of the contract and are not picked up by substituted work are "unabsorbed."⁵¹⁵ The boards of contract appeals and the courts view these unabsorbed indirect costs as ongoing business costs unrelated to the terminated contract and not recoverable.⁵¹⁶

Several commentators⁵¹⁷ strongly believe that post-termination unabsorbed overhead should be compensable, "particularly where the terminated contract represents a substantial portion of the contractor's work or where the obtaining of contracts in the industry requires substantial lead time."⁵¹⁸

Joseph and O'Donnell argue that post-termination unabsorbed overhead should be recoverable because:

- (1) Recovery is not prohibited by regulation or law.
- (2) The regulatory objective of fairly compensating the contractor is thwarted when denial of unabsorbed overhead results in a loss to the contractor.⁵¹⁹

(3) Recovery of unabsorbed overhead is permitted by the Government in analogous contexts such as partial terminations and delay.

(4) Recovery of unabsorbed overhead incurred after contract termination is permitted in commercial practice.⁵²⁰

Paul Trueger devotes 18 pages of his text, *Accounting Guide for Government Contracts*, to supporting his belief that such costs should be compensable.⁵²¹ In his opinion, equity requires compensation. The contractor deployed people, space, and facilities to perform the Government contract and when confronted with a unilateral decision to terminate cannot immediately "swing into business on new business the day after the abrupt Government action."⁵²² Furthermore, from a cost accounting viewpoint, he believes there is no basis to charge such costs to any cost objective other than the terminated contract which caused their unabsorption.⁵²³

Despite this criticism, boards and courts continue to deny unabsorbed overhead except in unusual circumstances.⁵²⁴ They view ongoing fixed indirect costs as simply the contractor's costs of remaining in business. The Government's obligation to a terminated contractor is to compensate it fairly for the work performed on the terminated contract and for its settlement costs.⁵²⁵ The Government's obligation stops there--the Government is not a guarantor of new work. A long line of cases supports denial of continuing overhead costs

after contract termination.⁵²⁶ If the law is to change, boards and courts see it as the duty of Congress or the drafters of the procurement regulations to make the change.⁵²⁷

The commentators' criticism that a contractor usually is not as well off financially when a contract is terminated before completion is valid. Not only does the contractor lose the profit it would have made on the terminated work but also the fixed indirect costs that the terminated work would have absorbed (unless termination allows the contractor to obtain substitute work that the contractor would not otherwise have obtained).⁵²⁸ Noting the validity of such criticism, does not lead to the conclusion that contractors should recover post-termination unabsorbed overhead.⁵²⁹ A contractor's financial position, while hurt by the termination, may have been considerably enhanced by the unterminated portion of the contract. Without this unterminated work the contractor might have had even less work during the period to absorb fixed indirect costs. Unless the contractor, in anticipation of the performance of the terminated contract, forwent other work which would have fully absorbed the continuing indirect costs, its financial position has not been adversely affected by acceptance of the contract.

But the question is not whether the contractor is as well off after termination as it would have been had the contract

proceeded to completion. The question is whether the Government should, or does, at the time of contracting, guarantee to the contractor that in the event of contract termination the contractor will recover its fixed indirect costs the same as if the contract had proceeded to completion.⁵³⁰

If the Government were to so guarantee, a contractor's recovery might be greater against the Government than against a private party despite the fact that anticipatory profits are not recoverable against the Government. At common law, upon termination for breach of contract an injured seller is entitled to recover as damages contract price less any costs saved by the termination. In many states fixed indirect costs incurred after termination are viewed as costs saved by the termination and are unrecoverable.⁵³¹

Allowing contractors to recover post-termination unabsorbed overhead would:

- (1) Change a time-honored scheme of recovery.
- (2) Make it more expensive for the Government to terminate contracts for its convenience and significantly alter the economics of a termination for convenience.
- (3) Require the Government to pay anticipatory indirect costs--a cost similar to, if not in fact, anticipatory profit.⁵³²

(4) Have the Government question a contractor's failure to bid on and obtain additional work in mitigation of the terminated contract.

How far the Government should go in making a contractor whole for the effects of a termination for convenience is a question that requires a complex balancing of interests and, as recognized by the ASBCA, is an area better suited to legislative change than judicial reform.⁵³³

Since the Government does not compensate contractors for unabsorbed overhead incurred after termination, Paul Trueger recommends direct charging of any overhead costs that can be characterized as continuing costs.⁵³⁴ He indicates his success in obtaining a substantial portion of unabsorbed overhead through direct charging for reasonable periods of time following termination.⁵³⁵

VI. PARTIAL TERMINATIONS FOR CONVENIENCE

When the Government terminates only a portion of the work called for under the contract, the contract is partially terminated for convenience. Under the Termination for Convenience clause, a contractor is entitled to its costs incurred in preparing to perform and in performing the terminated portion of the contract, reasonable profit thereon, and its costs of preparing the termination

settlement proposal, plus an equitable adjustment for any increased costs caused by the termination in performing the unterminated portion of the contract. In principle, there is little difference in pricing a contract partially terminated for convenience and one entirely terminated for convenience.⁵³⁶

Nonetheless, pricing a partial termination for convenience is more difficult than pricing a contract entirely terminated for convenience in that the parties must (1) segregate costs incurred for the terminated and unterminated portions of the contract, (2) determine the amount of contract price applicable to the terminated portion of the contract,⁵³⁷ and (3) determine the amount by which the cost of performing the unterminated portion of the contract increased as a result of the partial termination.

A. Indirect Costs of the Terminated Portion of the Contract

Indirect costs of the terminated portion of the contract are determined just as if the contract had been completely terminated, except that nonrecurring indirect costs (e.g., start-up costs) must be allocated between the terminated and unterminated portions of the contract.⁵³⁸ Had the contract had been entirely terminated for convenience these

nonrecurring costs would be recovered in their entirety as part of the termination settlement.

B. Indirect Costs of the Underminated Portion of the Contract

The underminated portion of the contract remains priced at the original contract price.⁵³⁹ However, a contractor is entitled to an equitable adjustment for any increased costs of performing the underminated portion of the contract caused by the termination.⁵⁴⁰ The contractor's costs of performing the underminated portion of the contract may be increased by a variety of factors including: inability to take advantage of volume discounts on purchases,⁵⁴¹ loss of learning curve benefits,⁵⁴² unabsorbed nonrecurring direct costs,⁵⁴³ and unabsorbed fixed indirect costs.⁵⁴⁴

1. Volume Discounts, Learning Curve Benefits, and Unabsorbed Nonrecurring Direct Costs

A partial termination for convenience may reduce the quantity of material needed for performance and the volume of purchases made by the contractor. As a result of not buying in quantity the contractor's unit cost of materials for the underminated portion of the contract may increase. Similarly, the unit cost of the underminated portion of the contract may increase as a result of loss of learning curve

benefits.⁵⁴⁵ The first units of a lot produced often cost substantially more to produce than the last units in that the people producing the units as they gain experience become more proficient. A partial termination for convenience deletes the latter less costly units of production, thereby increasing the average cost of the unterminated units. The unit cost of the unterminated work is also increased when nonrecurring direct costs such as special tooling are allocated over a smaller number of units.

The contractor is entitled to an equitable adjustment for its increased costs of performing the unterminated portion of the contract in each of the situations described above. For purposes of an equitable adjustment the contractor first determines how much the direct costs of performing the unterminated portion of the contract were increased. The indirect cost portion of the equitable adjustment usually is determined by multiplying the contractor's normal indirect cost rate by the increase in direct costs.⁵⁴⁶

2. Unabsorbed Indirect Costs

A partial termination for convenience may reduce the volume of work performed during an accounting period thereby causing each of the contractor's cost objectives to bear an increased portion of fixed indirect cost. When this happens, a contractor is entitled to an equitable adjustment in the

price of the unterminated portion of the contract.⁵⁴⁷ Note that all partial terminations for convenience do not reduce a contractor's distribution base--a contractor may be incapable of performing even the unterminated portion of the contract within the accounting period or may obtain substitute work.⁵⁴⁸ To obtain an equitable adjustment, a contractor must prove that the partial termination for convenience in fact reduced its distribution base.⁵⁴⁹

The equitable adjustment compensates the contractor for the unterminated portion of the contract's proportionate share of the fixed indirect costs that would have been absorbed by the terminated work. The computation is a five step process: (1) remove variable indirect costs from the indirect cost grouping; (2) determine the contractor's actual fixed indirect cost rate; (3) determine what the contractor's fixed indirect cost rate would have been had the contract not been partially terminated; (4) subtract this indirect cost rate from the actual fixed indirect cost rate; and (5) multiply the rate differential by the direct costs of the unterminated work to obtain the unabsorbed overhead allocable to the unterminated portion of the contract.⁵⁵⁰ Reasonable profit should be added to the unabsorbed overhead computation.⁵⁵¹

In several cases involving partial terminations for convenience, the ASBCA erred in measuring unabsorbed overhead. In *Celesco Industries, Inc.*, the Board compared

the indirect cost rate used by the contractor in preparing its bid to the contractor's actual indirect cost rate to determine whether the partial termination had caused unabsorbed overhead.⁵⁵² Because the actual indirect cost rate was lower than the rate upon which the bid was based the Board determined the contractor suffered no harm and denied recovery of unabsorbed overhead.⁵⁵³ The Board's comparison of bid indirect cost rates to actual indirect cost rates measures the amount by which the initial contract price would have increased had the parties known at the time of contracting what the contractor's actual indirect cost rate would be--which is irrelevant.⁵⁵⁴ The Board ignored the fact that the partial termination *increased* the contractor's costs of performing the unterminated portion of the contract finding it inconsequential that actual indirect cost rates were higher than they would have been had the contract not been partially terminated.

In *Wheeler Brothers, Inc.*, a requirements contract was partially terminated for convenience (constructively) when the Government purchased automotive parts from dealers other than Wheeler Brothers.⁵⁵⁵ The Board awarded Wheeler Brothers a \$398,687 equitable adjustment to the contract price of the unterminated portion of the contract for unabsorbed overhead. The questionable portion of the opinion was the Board's assumption, in the absence of evidence by the Government to the contrary, that the contractor's indirect costs would not

have increased had the contract not been partially terminated.⁵⁵⁶ The Board assumed that actual overhead for the period, \$1,360,025, at a sales volume of \$6,751,685 would remain unchanged had sales volume increased by 40 percent to \$9,551,685. Rarely will any contractor's overhead costs be entirely fixed costs (i.e., include no variable cost elements).⁵⁵⁷ The Board's decision is objectionable from another perspective as well. It is the contractor who has the burden of proof and must prove quantum. In the absence of evidence as to what portion of an indirect cost grouping is variable, boards should find that the contractor has not met its burden of proof and limit or deny recovery accordingly.

CHAPTER 5

CONSISTENCY

The purpose of this chapter is to discuss the consistency requirement as it applies to equitable adjustments and terminations for convenience. Much of Chapter 5 discusses consistency in seemingly general terms because (1) consistency issues, to a large degree, are the same whether it is a cost reimbursement or cost plus fixed fee contract, an equitable adjustment or a termination for convenience that is being priced;⁵⁵⁸ (2) the case law arises primarily in the context of cost reimbursement or cost plus fixed fee contracts; and (3) the procurement regulations address consistency in general terms. Separate discussion of general but important consistency issues would be needlessly repetitive.

Issues of consistency are more complex for equitable adjustments and terminations for convenience than for cost reimbursement and cost plus fixed fee contracts. This is because equitable adjustments and termination settlement agreements are pricing actions necessitated by change--it is in the context of this change that issues of consistency arise. Although the issues are more complex, the courts and boards decide these issues with less explanation than they do for a cost reimbursement or cost plus fixed contract. For equitable adjustments consistency is usually a subsidiary

issue, the fact of inconsistency in many instances is obvious, and dollar amount small in proportion to consistency issues arising in the context of a cost reimbursement or cost plus fixed fee contract. For terminations for convenience (1) the procurement regulations specifically permit direct charging of certain costs that otherwise would be charged indirectly and (2) absent cost accounting systems capable of measuring costs accurately at various stages of contract completion, recovery does not depend upon accounting to the degree that it does for cost reimbursement contracts, but depends in substantial part on the board or court's determination of fair compensation.

Consistency has been discussed in Chapters 2, 3, and 4, as it applies to subject matter of those chapters. This chapter addresses consistency in more general terms. It begins with a discussion of the purpose and sources of the consistency requirement and then discusses inconsistent classification of costs as direct or indirect, assignment of costs to indirect cost groupings, distribution base selection, base period selection; changes in cost accounting practices; and consistency as it applies to equitable adjustments and termination settlements.

I. REQUIREMENT FOR CONSISTENCY

A. Purpose of Consistency Requirement

Consistency in accounting for costs is a fundamental accounting principle.⁵⁵⁹ Consistency provides a common basis for comparison. It enhances comparison of costs by period, product line, and division. It also enhances comparison of estimated with actual costs. The value of consistency is that it eliminates differences caused by varying methods of recording, measuring, and allocating costs leaving decision makers with just differences important to the decision making process.

Consistency in accounting for costs also reduces the likelihood of error. As employees become more familiar with accounting practices and procedures, they make fewer bookkeeping errors. Furthermore, consistency increases the likelihood that all costs of a particular cost objective will be charged to that cost objective and that the cost objective will not have the same cost charged to it more than once.

Consistency enhances the acceptability of an accounting system for cost measurement purposes. It provides some assurance that a contractor's accounting practices and procedures were chosen for their ability to impartially

approximate cost rather than to maximize the cost charged to a particular cost objective.

Consistency, however, is not always obtainable or desirable. Accounting systems must change as the product mix, organizational structure, and/or needs of the organization change. Accounting practices that once equitably allocated costs to the several cost objectives may no longer do so as new products are added or new production techniques implemented. The objective is to balance the need for consistency with the need to change in response to changing circumstances.

B. Source of the Consistency Requirement

Consistency is required by GAAP, the Cost Principles, and by the CAS. Boards and courts seldom refer to these sources when faced with consistency issues but instead address the requirement for consistent accounting treatment in terms of preventing over recovery of cost.

1. Generally Accepted Accounting Principles

In Chapter 1, the usefulness of GAAP as a guide for measuring, accumulating, and allocating costs was questioned because GAAP were developed primarily for financial reporting--not for cost accounting--purposes and because of

the large number of often conflicting sources of authority for GAAP.⁵⁶⁰ However, GAAP unquestionably require consistency.⁵⁶¹ Consistency is an absolute requirement of accounting for both financial reporting and cost accounting purposes.

2. The Cost Principles

The Cost Principles are mandatory for pricing equitable adjustments and terminations for convenience.⁵⁶² Under the Cost Principles, allowable costs are determined in accordance with the CAS, if applicable, otherwise in accordance with GAAP.⁵⁶³ As explained in this Chapter, both the CAS and GAAP require consistency.

In addition to incorporating the consistency requirements of the CAS, if applicable, and if not, of GAAP, specific Cost Principle provisions require contractors to be consistent in classifying costs as direct or indirect.⁵⁶⁴ FAR Part 31 prohibits direct charging of any costs that have been charged indirectly in like circumstances. "No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective."⁵⁶⁵ Similarly, FAR Part 31 also prohibits indirect charging of any costs that have been charged

directly in like circumstances. "An indirect cost shall not be allocated to a final cost objective if other costs incurred for the same purpose in like circumstances have been included as a direct cost of that or any other final cost objective."⁵⁶⁶

The Cost Principles, literally applied, would preclude any recovery of a cost (either directly or indirectly) if other costs incurred for the same purpose in like circumstances had been charged directly in one instance and indirectly in another--even if the inconsistency did not involve the Government and the cost were otherwise properly allocable to a Government contract. In practice, boards and courts will be hesitant to entirely deny recovery of a cost reasonably incurred and otherwise allocable to the contract.⁵⁶⁷

3. The Cost Accounting Standards

The consistency requirements of the CAS are set forth in CAS 401 and 402. CAS 401 and 402 apply whenever a contract is subject to either full or modified CAS-coverage.⁵⁶⁸ Disclosure by a contractor of its accounting practices, at the contract's inception allows the Government to ascertain later whether or not the contractor is in fact being consistent.⁵⁶⁹ Under both CAS 401 and 402, contractors are permitted to make changes in their accounting practices.

Such changes, however, must be accomplished through initiation of a formal accounting change.

a. Cost Accounting Standard 401--Consistency in Estimating, Accumulating, and Reporting Costs

CAS 401 requires contractors to follow consistent cost accounting practices in estimating, accumulating and reporting costs.⁵⁷⁰ Specifically,

[C]osts estimated for proposal purposes shall be presented in such a manner and in such detail that any significant cost can be compared with the actual costs accumulated and reported therefor. In any event the cost accounting practices used in estimating costs, in pricing a proposal and in accumulating and reporting costs on the resulting contract shall be consistent with respect to: (1) [t]he classification of costs as direct and indirect; (2) the indirect cost pools to which each element or function of cost is charged or proposed to be charged; and (3) methods of allocating indirect costs to the contract.⁵⁷¹

Consistency in estimating, accumulating and reporting costs improves comparability of actual⁵⁷² with estimated costs. The result is better financial control over costs during contract performance and easier evaluation of a contractor's estimating capabilities.⁵⁷³ Note that CAS 401 permits a contractor to use greater detail in accumulating and reporting costs⁵⁷⁴ than in estimating costs.⁵⁷⁵ A contractor violates CAS 401 when it does not use the same cost accounting practices to determine the amount of a request for payment (reporting costs) as it did to estimate its costs of

performance.⁵⁷⁶ Failure to follow consistent accounting practices when preparing a request for payment results in payment being disallowed to the extent that it exceeds what would have been payable had the contractor followed consistent accounting practices.⁵⁷⁷

For a prospectively priced change order, CAS 401 requires contractors, subject to the CAS, to estimate costs using the same cost accounting practices that will be used to accumulate and report such costs. For a termination for convenience, CAS 401, requires contractors, subject to the CAS, to accumulate and report, to the extent possible, pre-termination costs using the same cost accounting practices that were used to originally estimate costs of performing the contract.

To date, CAS 401 has not played a major role in the pricing of equitable adjustments or termination settlements. CAS 401, if discussed, is mentioned in the context of defective pricing. No case so far has discussed CAS 401 as it relates to an equitable adjustment or a termination settlement. Nonetheless, if the contract is CAS-covered, contractors are required to follow CAS 401 when preparing proposals for equitable adjustments or termination settlements.

b. Cost Accounting Standard 402--Consistency in
Allocating Costs Incurred for the Same Purpose

"Whereas CAS 401 is concerned with consistency between estimated and actual costs, CAS 402 is concerned with the treatment of costs as direct or indirect."⁵⁷⁸ The purpose of CAS 402 is to ensure that "each type of cost is allocated only once and on only one basis to any contract or other cost objective."⁵⁷⁹ By requiring consistent treatment of costs as either direct or indirect, CAS 402 eliminates a potential means for overcharging Government contracts.⁵⁸⁰ The fundamental requirement of CAS 402 is:

All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.⁵⁸¹

Consistency is determined by comparing the cost accounting practices employed by a contractor to its established accounting practices as described in its Disclosure Statement.⁵⁸² If a Disclosure Statement is not on file the contractor's accounting practices in use at the time of contract proposal are considered its established accounting practices.⁵⁸³ When use of a contractor's disclosed or

established accounting practices will cause an inequitable distribution of costs, contractors are permitted to change to accounting practices that equitably distribute costs.⁵⁸⁴ Once adopted, an accounting change must be followed consistently thereafter.

The key to applying CAS 402 is understanding what is meant by the phrase "cost incurred for the same purpose in like circumstances."⁵⁸⁵ The meaning of this phrase is discussed in the following section.

II. APPLICATION OF THE CONSISTENCY REQUIREMENT

Consistent accounting treatment is very important to the recovery of indirect costs, whether recovered as part of an equitable adjustment or termination settlement. Inconsistent treatment of costs allows contractors to game their accounting systems to maximize recovery of costs from the Government, when instead their accounting systems should impartially measure the amount of cost which Government contracts and commercial cost objectives, respectively, should bear.⁵⁸⁶

Contractor's should be consistent in:

- (1) Classifying costs as direct or indirect
- (2) Assigning costs to indirect cost groupings

(3) Distributing indirect cost groupings to the several cost objectives

(4) Selecting a base period.

Double counting or over recovery of cost may result from failure to be consistent as explained below.

A. Classifying Costs as Direct or Indirect

Costs are classified as direct costs if (1) the beneficial or causal relationship between incurrence of the cost and the final cost objective is clear and exclusive, (2) the amount of the cost is readily and economically measurable, and (3) all other costs incurred for the same purpose in like circumstances can be identified specifically with final cost objectives and accounted for as direct costs.⁵⁸⁷ Similarly, costs are classified as indirect costs when these conditions are not met.⁵⁸⁸

The classification principles are general in nature⁵⁸⁹ leaving room for contractors to exercise judgment as to which costs can be economically identified with separate final cost objectives.⁵⁹⁰ Contractors exercise this judgment when they initially establish their cost accounting practices. Once cost accounting practices are established, the contractor has limited discretion in reclassifying costs as direct or indirect.⁵⁹¹ All costs must be classified in accordance with

the contractor's established cost accounting practices until such time as the contractor's established cost accounting practices become inequitable and are changed.⁵⁹² An exception occurs when a contractor's established cost accounting practices classify costs as direct or indirect in obvious conflict with the FAR or other regulatory guidance.⁵⁹³ Regulatory requirements for cost classification take precedence over a contractor's established cost accounting practices.

1. Overcharging Results from Inconsistent Classification of Costs as Direct or Indirect

Inconsistent classification of costs as direct or indirect causes overcharging in four ways.

(1) When a cost is charged directly to a government contract and is also allocated as an indirect charge to the contract, the contractor is recovering the same cost both directly and indirectly.⁵⁹⁴

(2) When a normally indirect cost is charged directly to a Government contract, failure to remove other costs incurred for the same purpose in like circumstances from the indirect cost grouping⁵⁹⁵ causes the Government contract to bear, as a direct cost, the total amount of a particular cost that it

generated plus, as an indirect charge, a portion of the particular cost generated by other contracts.

(3) When a normally direct cost incurred for the benefit of a commercial contract is included in an indirect cost grouping and other costs incurred for the same purpose in like circumstances are charged directly, a Government contract will bear, as a direct cost, the total amount of a particular cost that it generated plus, as an indirect charge, a portion of the particular cost generated by the commercial contract.⁵⁹⁶

(4) When a contractor reclassifies costs as direct or indirect depending upon the type of contract and the economic conditions experienced or expected during contract performance overcharging is caused as illustrated below:

[A] contractor proposes to charge certain costs as direct because the anticipated cost level is higher than the historical cost level. On its next contract, however, the contractor proposes to charge these costs as indirect because the anticipated cost level is lower than the historical level. E.g., the overhead rate is 150 percent of direct labor dollars, and travel is 10 percent of overhead (or 15 percent of direct labor dollars). The contractor estimates that the new contract travel will amount to 20 percent of direct labor dollars. If it reclassifies travel as "direct," its overhead rate will drop to 135 percent of direct labor dollars, but it will also recover travel in the amount of 20 percent of direct labor dollars, or a total recovery of 155 percent of direct labor dollars. On the next contract if travel is estimated as 10 percent of direct labor dollars, the contractor reclassifies travel as "indirect" and recovers overhead at 150 percent of direct labor, instead of at 135 percent plus 10 percent.⁵⁹⁷

2. "Costs Incurred for the Same Purpose in Like Circumstances"

The Cost Principles and CAS 402 both require contractors to be consistent in their classification of costs as direct and indirect and they use similar language to do so.⁵⁹⁸ The language used to establish the requirement is:

No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.⁵⁹⁹

The key to applying the consistency requirement of either the Cost Principles or CAS 402 lies in determining what constitutes "a cost incurred for the same purpose in like circumstances." The Cost Principles offer no guidance other than what can be inferred from their allowance of certain normally indirect costs as direct charges.⁶⁰⁰ Guidance is provided by CAS 402 and by the boards and courts.

a. CAS 402 Guidance

CAS 402 establishes a two part test for determining whether a contractor's classification of a cost as direct or indirect is consistent with its classification of other costs. If a

cost is not "incurred for the same purpose" or if the circumstances are different, the contractor is free to classify it without regard to how other costs were classified. CAS 402 briefly discusses both parts of the test.

(i) Costs Incurred for the Same Purpose. CAS 402 provides two illustrations of "costs incurred for the same purpose."⁶⁰¹ Illustration one: A contractor normally charges all travel costs indirectly. For purposes of a new proposal, the contractor intends to classify the travel costs of personnel whose labor will be charged directly to the contract as a direct cost. The travel costs of personnel whose time is accounted for as direct labor working on other contracts are "costs incurred for the same purpose" and may no longer be included within indirect cost pools allocated to any covered Government contract.⁶⁰² The illustration suggests that the travel costs of direct cost employees and travel costs of indirect cost employees are incurred for different purposes. Restated, costs "directly associated" with a direct cost are incurred for a different purpose than costs directly associated with indirect costs.⁶⁰³ A second point is made as well: the fact that the type of cost (travel) is the same does not, in and of itself, make the purpose the same. Illustration two: "A contractor normally charges planning costs indirectly and allocates these costs to all contracts on the basis of direct labor. A

proposal for a new contract requires a disproportionate amount of planning costs."⁶⁰⁴ The contractor may not charge the planning costs as direct costs.⁶⁰⁵ The illustration demonstrates that the amount of cost incurred does not change the purpose for which it was incurred.

CAS 402 also provides two illustrations of costs "not incurred for the same purpose."⁶⁰⁶ Illustration one: The contractor's Disclosure Statement indicates that special tooling and general purpose tooling serve different purposes and that it is the contractor's practice to charge special tooling as a direct cost and general tooling as an indirect cost. Since the costs are not costs incurred for the same purpose, the contractor does not violate the standard by charging special tooling costs directly to the contract and general purpose tooling costs indirectly. The illustration shows that (1) special tooling is incurred for a different purpose than general purpose tooling and (2) the fact that the type of cost (tooling) is the same does not, in and of itself, make the purpose the same. Illustration two: A contractor proposes to perform a contract which will require three fixed-post firemen for highly inflammable materials used on the contract. The contractor presently employs ten firemen for general protection of the plant. It intends to charge to the contract the salaries of fixed-post firemen as a direct cost and allocate to the contract a portion of the salaries of general purpose firemen as an indirect cost.

This is permissible in that the function performed by the fixed-post firemen--protecting highly flammable materials for a specific contract--is different from the function of the general purpose firemen-- providing overall plant protection.

(ii) Costs Incurred In Like Circumstances. The CAS Board has issued an Interpretation discussing "costs incurred in like circumstances" as applied to bid and proposal costs.⁶⁰⁷ The Interpretation states:

Under 30.402, costs incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs incurred in preparing proposals which do not result from such specific requirement. The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.⁶⁰⁸

Thus, under CAS 402, costs specifically required by an existing contract provision are incurred under different circumstances than costs not specifically required.

This interpretation is the only guidance issued by the CASB explaining what constitutes a cost incurred in like circumstances.

b. Decisions of the Boards and Courts

Unfortunately, case law provides little guidance as to what constitutes "other costs incurred for the same purpose in like circumstances." Boards and courts seldom decide cases by applying the language "other costs incurred for the same purpose in like circumstances" to the facts of a particular case.⁶⁰⁹ They do not say, "this is a cost incurred for the same purpose because. . . ." or "this is a cost incurred in like circumstances because. . . ." Most decisions address inconsistency where the cost in question obviously was incurred for the same purpose and in like circumstances as other costs--explanation as to why the purpose is the same and why the circumstances are like is unnecessary.⁶¹⁰

However, the case law has discussed consistency in two commonly occurring factual patterns where it is not self evident that the cost was incurred for the same purpose and in like circumstances as other costs. The factual patterns are: (1) one of the several cost objectives requires more of an indirect cost than other cost objectives and (2) direct cost functions are performed by an employee or officer whose salary is normally charged indirectly.

(i) One of Several Cost Objectives Requires More of an Indirect Cost than Other Cost Objectives

Often one contract requires more of a particular indirect resource than do other cost objectives. In most cases, this resource is the time of a supervisor, an officer of the firm, or an administrative person.⁶¹¹ When a contract requires more of an indirect cost than other cost objectives require, the contractor naturally wants to be compensated accordingly. If the contractor's indirect cost base does not provide this additional compensation, the contractor often attempts to charge the cost directly to the contract.⁶¹² Boards and courts have not allowed contractors to charge these costs directly even when the contractor specifically identifies the cost to the contract and proves that its allocation system does not fully compensate it for this indirect cost on this contract.⁶¹³

The case law is correct in denying direct recovery. Direct recovery, if allowed, would create numerous opportunities for overcharging the Government and significantly increase audit and administrative costs.⁶¹⁴ To prevent overcharging the following actions would be necessary: (1) direct charging of indirect cost resources of which the Government contract used a disproportionately small share; (2) treating commercial cost objectives in a like manner as Government contracts; i.e., identifying and charging as direct costs to commercial

contracts indirect cost resources of which they required more of than other cost objectives; and (3) making certain that the reclassified cost and other indirect costs incurred for the same purpose are removed from indirect cost groupings prior to distribution to the specially affected contract. As a practical matter, it would be extremely difficult for the Government to determine whether these actions in fact were taken.

Obviously, the mere fact that a contract requires more of a particular indirect cost than other cost objectives does not effect the purpose for which the cost was incurred. The pertinent question is whether the increase in quantity constitutes a sufficient change in circumstances to permit direct charging? As indicated above, boards and courts have found that it does not.⁶¹⁵ This does not necessarily mean that the contractor must suffer a loss on a contract requiring a disproportionate amount of indirect cost effort. The contractor can propose a change to its accounting system⁶¹⁶ or in exceptional cases can obtain a special allocation from the indirect cost grouping.⁶¹⁷

(ii) Direct Cost Functions Performed by an Employee or Officer Whose Salary Is Normally Charged Indirectly

When an employee or officer, whose salary is normally charged as an indirect cost, performs direct cost functions, a

contractor may try to recover part of the person's salary as a direct cost. Boards and courts have allowed direct recovery of time spent by an employee performing direct cost functions and indirect recovery of the remaining portion.⁶¹⁸

A representative case is *Airtech Services, Inc.*⁶¹⁹ For services rendered as project managers, the contractor charged directly to the contract a portion of the salaries of two corporate executives; the remainder of the two salaries was included in an indirect cost pool. The contracting officer, relying on the procurement regulations, removed the two salaries from the indirect cost pool, reasoning that because a portion of the salaries had been charged directly, the remaining portion must be charged directly as well. The Board interpreted FPR 1-15.202(a) as not requiring that a person's salary be charged entirely as a direct cost or entirely as an indirect cost.⁶²⁰ The consistency requirement under FPR 1-15.202(a) was expressed in the following language. "When items ordinarily charged as indirect costs are charged to Government work as direct costs, the costs of the like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work." The question before the DOT CAB was whether a person's time was a like item regardless of the function being performed. The Board reasoned that a person's time could be charged directly in one instance and indirectly in another so long as different functions were performed.

Applying the functional test case, the Board expressed the FPR requirement as follows: "if any part of the work effort of these two executives during the base year can be specifically identified with other projects of the contractor, then recompense for that effort shall be charged directly to these other projects and shall be eliminated from the indirect costs allocated to this contract."⁶²¹ The Board found no evidence in the record that either executive had acted as project manager for any other project or that either had become so actively engaged in any other projects that a portion of their salary should be specifically identified with such projects.

As *Airtech Services* illustrates, it is not necessarily inconsistent to charge a portion of a person's salary as a direct charge and the remainder indirectly. However, the work for which the direct charge is permitted must vary qualitatively from work normally performed.⁶²² A direct charge is not warranted simply because a contractor spends significantly more time on one cost objective than on others.

B. Assignment of Costs to Indirect Cost Groupings

Contractors often have a number of indirect cost groupings.⁶²³ They must assign costs to these indirect cost groupings in a consistent manner.⁶²⁴ The indirect cost grouping to which a cost is assigned determines how it is

distributed to the several cost objectives. Indirect cost groupings are distributed using different distribution bases and often to different cost objectives.⁶²⁵ For example, a cost included in a factory overhead pool usually is distributed to those cost objectives that generate direct labor and in proportion to the direct labor generated. On the other hand, a cost included in a G&A pool usually is distributed to cost objectives on the basis of cost input and to cost objectives in addition to those that generate direct labor. Inconsistent assignment of cost to indirect cost groupings can significantly increase the amount of indirect cost charged to a Government contract.⁶²⁶ Consistency requires (1) advance determination on how costs will be assigned to indirect cost groupings and (2) close adherence to that determination.

C. Distribution of Costs to the Several Cost Objectives

Once a distribution base is selected for an indirect cost grouping it must be consistently followed from accounting period to accounting period.⁶²⁷ Furthermore, this distribution base must be used to allocate all costs within an indirect cost grouping.⁶²⁸ When a cost objective benefits significantly more or less than other cost objectives from the incurrence of indirect costs, there is incentive to distribute indirect costs to this cost objective using a

separate distribution base.⁶²⁹ However, doing so is an inconsistent accounting practice and is not permissible.⁶³⁰ If a cost objective consistently benefits more or less than other cost objectives from an indirect cost grouping, the contractor should consider changing its distribution base to one that more equitably allocates costs to all cost objectives.⁶³¹

Consistency also requires that each unit of a contractor's distribution base be burdened with a pro rata share of the indirect cost grouping.⁶³² Thus, unallowable costs cannot be excluded from a distribution base but must bear a pro rata share of indirect cost.⁶³³

D. Base Period Selection

Normally, a contractor will select a calendar or fiscal year as its base period for accumulating indirect costs.⁶³⁴ Once adopted, a base period should be used consistently over time and all of a contractor's costs should be accumulated using that base period.⁶³⁵

By selectively changing the length of its base period a contractor can improperly increase its recovery of indirect costs. For example, significant fourth quarter indirect costs might encourage a contractor to price a Government change order performed during the fourth quarter by using

that quarter as its base period rather than its customary base period of one year.⁶³⁶ Such use would result in the change order bearing more indirect costs than if the contractor's customary one year base period were used. Similarly, if a construction contract were terminated for convenience in its second year, use of the period of contract performance as the base period rather than each individual year might result in over recovery of indirect costs if most of the pre-termination work took place in a year when indirect costs were low or volume high.⁶³⁷

Selectively changing the time at which the period begins can cause over recovery of indirect costs. For example, if a contractor had little work in the last quarter of its prior year, beginning the following base period to include that last quarter would enable the contractor to assign the indirect costs of that last quarter against Government change orders occurring in the new base year. Selective changing of this type is an inconsistent accounting practice and any additional recovery of indirect costs generated should be disallowed.

III. Change in Cost Accounting Practice

Consistency is not always obtainable or desirable; circumstances change and when they do, cost accounting practices that were once equitable, may become

inequitable.⁶³⁸ Either the Government or the contractor can request a change in the contractor's established accounting practices. Refusal of the other party to agree is not necessarily determinative because a board or court will give effect to a change if (1) the established accounting practice is inequitable and (2) the new practice equitably distributes cost.⁶³⁹

A cost accounting practice becomes inequitable when it no longer distributes indirect costs between the contractor's commercial and Government work in reasonable proportion to the benefits received. However, an accounting practice is not inequitable because it does not distribute costs to a particular cost objective in reasonable proportion to the benefits received.⁶⁴⁰ Nor is an accounting practice inequitable merely because a different accounting practice would decrease the Government's costs or increase the contractor's recovery.⁶⁴¹

Contractor's are not usually permitted to make accounting changes that are applicable only to certain contracts or portions of their business.⁶⁴² To be effective, the change must apply to the contractor's entire business.

A. Change Under the CAS

A contractor, subject to either full or modified CAS coverage,⁶⁴³ must follow its disclosed and/or established cost accounting practices.⁶⁴⁴ However, a change in cost accounting practice⁶⁴⁵ is permissible when changing circumstances make established cost accounting practices inequitable.⁶⁴⁶ Changes to cost accounting practices can be applied only prospectively to CAS-covered and modified-CAS-covered contracts.⁶⁴⁷ If a contractor has a Disclosure Statement on file, the contractor must amend the Disclosure Statement to reflect the change.⁶⁴⁸ Contractors must notify the contracting officer, in writing, of a proposed change 60 days before its proposed implementation.⁶⁴⁹ Notification is to include a description of the accounting change and the general dollar effect the change will have on all the contractor's CAS-covered contracts and subcontracts.⁶⁵⁰ After notification of the change, the contractor is required to submit a cost impact proposal.⁶⁵¹ The contracting officer will analyze the cost impact proposal to determine whether the proposed change will result in increased costs being paid by the Government.⁶⁵² If the proposed change decreases costs, a downward equitable adjustment will be negotiated.⁶⁵³ However, the Government will allow a cost increase only if the contracting officer determines that the change is "desirable and not detrimental to the Government."⁶⁵⁴

If a contractor fails to follow its disclosed and/or established accounting practices and as a result Government costs are increased, the Government is entitled to a downward adjustment of the contract price (fixed price contract)⁶⁵⁵ or cost allowance (cost reimbursement contract).⁶⁵⁶ The contractor will be required to correct its noncompliance and to submit a cost impact statement.⁶⁵⁷ The amount of the downward adjustment is the increase in costs paid by the Government as a result of the inconsistency plus interest.⁶⁵⁸

B. Change When the CAS Are Not Applicable

Contractors not subject to the CAS can also change their cost accounting practices when such practices become inequitable.⁶⁵⁹ Likewise, when changing circumstances make established cost accounting practices inequitable to the Government, the Government will request that the contractor make changes. If the contractor refuses to do so, the contracting officer will disallow any costs above what, in his/her opinion, equitable cost accounting practices would allow.⁶⁶⁰

The regulations do not prescribe procedures for making changes to non-CAS-covered contracts nor do they require affirmative disclosure of such changes other than as required by GAAP.⁶⁶¹ Despite the lack of formal procedures, contractors should informally follow the procedures required

for CAS-covered contracts; that is, contractors should provide advance notice to the contracting officer explaining the change, why it is necessary and how the change is expected to impact cost.⁶⁶² Advance notice and "up front" dealing will enhance a contractor's chances of having its proposed change accepted.

C. Prospective Versus Retroactive Application of Changes

For CAS-covered and modified CAS-covered contracts changes in accounting practice can be applied prospectively only. However, for non-CAS-covered contracts retroactive application of a change in cost accounting change is permissible in certain circumstances.

1. CAS-Covered Contracts

FAR 30.201-4 requires that a clause be included in CAS-covered and modified-CAS-covered contracts precluding retroactive application of a change in cost accounting practice.⁶⁶³ Thus, under the terms of the contract retroactive change is not permissible and any increased costs resulting to the Government from retroactive application are unallowable.⁶⁶⁴ In those cases where a contractor can prove that the Government acquiesced in or approved the retroactive

application of a change in accounting practice, boards and courts probably will permit retroactive application.⁶⁶⁵

Limiting changes in cost accounting practice to prospective application seems harsh. By the time a contractor or the Government recognizes that use of a contractor's established cost accounting practices is inequitable due to a change in circumstances, the contract may be substantially performed. Because a change is prospective it is not effective as of the date of the change in circumstances. Thus, for the period of time between the change in circumstances and the date the change in cost accounting practice is implemented, the contractor either will be inequitably over or under compensated. On the other hand, applying the change prospectively adds certainty to the contractual relationship. The Government is relieved of the risk of paying additional compensation for work already completed; a contractor is relieved of the risk of refunding payment received or experiencing nonreceipt of expected payment. Prospective application of a change allows the adversely affected party to gage the future cost impact and plan accordingly.

b. Non-CAS-Covered Contracts

The terms of non-CAS-covered contracts normally do not preclude retroactive application of a change in cost

accounting practice.⁶⁶⁶ Even so, retroactive application is permitted only in exceptional cases.

Absent compelling reason, sound accounting practice dictates that contractors make changes to their accounting systems at the start of their fiscal year.⁶⁶⁷ A mid-year change creates two inconsistent accounting practices for the same accounting period and complicates cost measurement.⁶⁶⁸ Thus, mid-year changes in accounting practice are more difficult to justify than changes at the start of a contractor's fiscal year.⁶⁶⁹

Similarly, boards and courts have been reluctant to retroactively apply changes in cost accounting practice.⁶⁷⁰ A change in accounting practice can be retroactively applied only "where unusual circumstances in a contractor's operations do not become apparent until after completion of one or several contracts, or until expiration of a representative period of time."⁶⁷¹ The nature of commercial transactions demands finality at some point in time; the threat of a change in accounting practice being retroactively applied diminishes the ability of both the Government and the contractor to determine cost and act in reliance upon it.⁶⁷²

When the Government seeks to change the contractor's cost accounting practices, it is usually because such practices distribute a disproportionately large share of the contractor's indirect costs to Government cost reimbursement

and cost plus fixed fee contracts. Inequitable distribution of indirect costs that occurred before the effective date of the change can be corrected by giving the change retroactive effect. However, boards and courts normally refuse to do so.⁶⁷³ The reason is that the contractor would have to refund to the Government the overpayment received on cost reimbursement and cost plus fixed fee contracts and cannot after the fact reprice its fixed-price contracts to recover the refunded indirect costs.⁶⁷⁴ On balance, the boards and courts favor the contractor, preferring to have the Government pay more than its fair share of indirect costs than to force a "forfeiture" upon the contractor.⁶⁷⁵

Retroactive application of a change does not force a forfeiture upon the contractor despite the contractor's inability to reprice its fixed price contracts. As Chapter 1 explained, most pricing decisions are based on the interaction of supply and demand in the market--not on cost.⁶⁷⁶ Thus, it is rather unlikely that the contractor would have increased its bid for fixed-price contracts had it known at the time of bidding that less indirect costs would be absorbed by cost reimbursement and cost plus fixed fee contracts.⁶⁷⁷ In most circumstances, the contractor obtains a dollar for dollar increase in profit when cost reimbursement and cost plus fixed fee contracts bear an inequitably high share of indirect costs.

The real threat to the contractor from retroactively applying a change in accounting practice is that the contractor may have altered its financial position in reliance upon what it perceived were its profits for the period. For example, it may have paid out increased dividends, given bonuses, or made investments that it otherwise would not have made. Retroactive application of an accounting change may be inequitable for this reason.

IV. CONSISTENCY IN THE PRICING OF EQUITABLE ADJUSTMENTS

The usual method of determining indirect cost is by multiplying the contractor's indirect cost rate by the increased direct costs of performance caused by the event necessitating the equitable adjustment.⁶⁷⁸ When the contractor attempts to recover normally indirect costs through other methods consistency questions arise.

A. Direct Charging of Normally Indirect Costs

Boards and courts have not allowed contractors to reclassify indirect costs as direct costs for purposes of pricing equitable adjustments.⁶⁷⁹ The event necessitating an equitable adjustment is not viewed as a change in circumstance sufficient to permit reclassification. In the following two circumstances contractors often attempt to

reclassify normally indirect costs as direct costs: (1) a standard percentage markup (10-15% of direct cost) is used to determine recovery of indirect cost or (2) the contract terms limit the percentage markup for indirect costs. As Chapter 2 explains, the boards and courts have not permitted reclassification in either instance.⁶⁸⁰

Many costs normally charged indirectly could be specifically identified to the several cost objectives if it were economically feasible to do so.⁶⁸¹ A change to a contract that entitles a contractor to an equitable adjustment may make it economically feasible for a contractor to specifically identify normally indirect costs with the change, if by doing so, the contractor recovers these costs directly rather than indirectly. The economic incentive to recover normally indirect costs directly is greatest when a change order benefits substantially more from the incurrence of normally indirect costs than other cost objectives.⁶⁸² The economic incentive is lowest when the change order benefits less from the incurrence of normally indirect costs than other cost objectives.⁶⁸³

The fact that a change order may have benefited more from a particular indirect cost than other cost objectives does not alter the purpose or the circumstances for which the indirect cost was incurred.⁶⁸⁴ Direct charging of such costs is inconsistent with the contractor's established cost

accounting practices and results in over recovery.⁶⁸⁵ If reclassification is permitted and the reclassified cost is then burdened with a markup for indirect costs, the over recovery is compounded.⁶⁸⁶ As indicated above, boards seldom allow direct recovery of indirect costs even when the contractor can prove that a particular change order benefited more from an indirect cost than other cost objectives.⁶⁸⁷

B. Methods of Recovering Indirect Costs

1. Standard Markup for Indirect Costs

A contractor must use its normal indirect cost rate for purposes of pricing equitable adjustments.⁶⁸⁸ However, boards and courts have traditionally allowed use of a standard percentage markup, usually 10 to 15%, on direct costs of the change, in lieu of the contractor's indirect cost rate.⁶⁸⁹ Use of the standard markup has not been deemed an inconsistent accounting practice. However, when actual indirect cost rates are available or either party can prove a projected overhead rate computed in accordance with the contractor's established accounting practices such rates are used rather than the percentage markup on direct costs.⁶⁹⁰

2. Recovery of Indirect Costs During Delay

When a fixed-price Government contract is delayed, application of a contractor's indirect cost rate to the direct costs of performance may inequitably allocate fixed indirect costs to the delayed contract.⁶⁹¹ For this reason, another method of allocating fixed indirect costs is often used for the delay period; one such as method is the *Eichleay* formula.⁶⁹²

Use of an alternate method of assigning fixed indirect costs to the delayed contract during the delay period is permissible (i.e., is not an inconsistent accounting practice) because the delay constitutes a sufficient change in circumstances to permit use of changed procedures.⁶⁹³ However, a contractor cannot recover its fixed indirect costs during the delay period under a formula such as *Eichleay* and also recover its fixed indirect costs by applying its normal indirect cost rate to direct performance costs incurred during the delay.⁶⁹⁴

C. Bid and Proposal Costs

Under CAS 402, it is not an inconsistent accounting practice for a contractor to (1) charge directly the costs of preparing, submitting, or supporting proposals incurred pursuant to a specific requirement of an existing contract

and to (2) charge indirectly the costs of preparing, submitting, or supporting proposals not incurred pursuant to a specific requirement of the contract.⁶⁹⁵ "The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor."⁶⁹⁶

The Preambles to CAS 402 state that proposals submitted under the Changes clause can be charged directly to the affected contract because such proposals are specifically required by contract provision.⁶⁹⁷ The cost of proposals submitted under clauses other than the Changes clause, (e.g., Differing Sites Conditions, Suspension of Work, Stop-Work-Order, Government Delay of Work, and Termination for Convenience) can be charged directly as well.⁶⁹⁸ Direct charging is permissible only when it is the contractor's established accounting practice to recover bid and proposal costs specifically required by existing contracts as direct costs.⁶⁹⁹ However, when a change is cancelled before the incurrence of any direct costs, a contractor may be permitted to recover its bid and proposal costs directly notwithstanding its established accounting practices.⁷⁰⁰

V. CONSISTENCY IN THE PRICING OF TERMINATIONS FOR CONVENIENCE

When consistency is raised in the context of pricing a termination for convenience, the issue is seldom whether prior terminations for convenience were priced in the same manner. Terminations for convenience are irregularly occurring events for which few, if any, contractors would have established accounting practices.

The consistency requirement as it applies to terminations for convenience is in most respects identical to that of a cost plus fixed fee or cost reimbursement contract.⁷⁰¹ For example, consistency in the assignment of costs to indirect costs groupings and in use of the distribution base are identical.⁷⁰²

There are two major difference in the consistency requirement between cost plus fixed fee/cost reimbursement contracts and contracts terminated for convenience. First, under a termination for convenience, many normally indirect cost are recovered directly. The consistency requirement and how it affects reclassification of costs for terminations for convenience is discussed in Chapter 4.⁷⁰³ Second, under a termination for convenience, the period of contract performance (a period other than the contractor's fiscal

year) frequently is used as the base period for accumulating indirect costs.⁷⁰⁴

Use of the period of contract performance rather than the contractor's normal fiscal year as the base period for purposes of a termination for convenience should be considered an inconsistent cost accounting practice although it has not been recognized as such by the boards and courts. Under GAAP, contractors must consistently follow their established cost accounting practices (including choice of base period) until such time as they become inequitable.⁷⁰⁵ Although established cost accounting practices can be changed or, in some instances, exceptions can be made,⁷⁰⁶ proof that an established cost accounting practice is inequitable and that an alternative practice is equitable is a prerequisite to a change or exception.⁷⁰⁷ The fact of termination does not provide this proof. A termination for convenience seldom makes the contractor's fiscal year inequitable as a base period.⁷⁰⁸ Furthermore, the period of contract performance may be an inequitable alternative because as Chapter 2 explained, base periods of less than or greater than one year frequently fail to represent the contractor's normal operations.⁷⁰⁹ Finally, allowing contractors to selectively chose either their fiscal year or the period of contract performance as their base period depending upon which yields the most favorable result is inequitable to the Government.⁷¹⁰

CONCLUSION

The accurate determination of indirect costs for purposes of equitable adjustments and terminations for convenience presents a challenge to the Government contracting community. This challenge can be met only by understanding the cost allocation process--its mechanics and limitations.

This thesis addressed several important principles that affect recovery of indirect cost. First, changes in volume do not increase or decrease the amount of fixed indirect costs within the relevant range of production but do increase or decrease the proportionate share of fixed indirect cost absorbed by each unit of production. This is a fundamental principle that must be understood. It explains why, when volume changes, projected indirect cost rates fail to distribute fixed indirect costs accurately to the several cost objectives. It also provides the basis for unabsorbed overhead. A second fundamental principle is the need for consistency. Failure to follow consistent cost accounting practices causes some cost objectives to bear an inequitable portion of indirect costs. The illustrations in Chapter 5, explaining how inconsistent classification of costs as direct or indirect causes over recovery warrant careful study. Indirect costs should be reclassified as direct only when necessary to compensate the contractor equitably and then, steps should be taken to prevent over recovery.

In several areas the law is still developing. One such area is recovery of extended overhead. The concept is distinct from unabsorbed overhead. Analysis of extended overhead and the basis for its recovery has been hindered by its use as a synonym for unabsorbed overhead. The author's analysis shows that extended overhead should not be recoverable for two reasons: (1) the period of extended performance does not increase fixed indirect costs and (2) it does not decrease the volume of work performed by the contractor (i.e., has no effect on the number of units of production available to absorb fixed indirect costs). The second unsettled area of the law is measurement of unabsorbed overhead. The *Eichleay* formula has been used by the boards of contract appeals for over 25 years and its use was affirmed in 1984 by the Court of Appeals for the Federal Circuit. Notwithstanding, the *Eichleay* formula infrequently measures unabsorbed overhead correctly. Unfortunately, attempts to discredit the *Eichleay* formula have been unsuccessful for two reasons: (1) an acceptable alternative has not been offered and (2) the presumptions upon which the formula rests have not been fully analyzed. This thesis argues that unabsorbed overhead can be measured more accurately through estimation than through use of any formula including the *Eichleay* formula. The author recognizes that formulas can measure unabsorbed overhead accurately if the presumptions upon which they are based are valid. Before using any formula to measure unabsorbed

overhead, one must examine the presumptions upon which the formula's validity depends, determine whether they are valid under the circumstances, and if they are not valid, adjust the formula's computation of unabsorbed overhead accordingly. Chapter 3 identified six presumptions upon which the *Eichleay* formula's validity rests.

This thesis explained the basic elements and problem areas associated with the recovery of indirect costs for equitable adjustments and termination settlements. The author's purpose in clarifying these areas is to promote a better understanding of how indirect costs are recovered with the hope that this understanding will lead to more accurate cost measurement.

FOOTNOTES

¹J. CIBINIC & R. NASH, ADMINISTRATION OF GOVERNMENT CONTRACTS, 267 (2d ed. 1985).

²FAR 52.243-4.

³Cibinic & Nash, *supra* note 1, at 281.

⁴Suspension of Work clause, FAR 52.249-10.

⁵FAR 52.236-2.

⁶ Cibinic & Nash, *supra* note 1, at 350.

⁷Defense Contract Audit Pamphlet (DCAAP) 7641.45, AUDIT GUIDANCE DELAY AND DISRUPTION CLAIMS, p.1 (1983).

⁸L. ANDERSON, ACCOUNTING FOR GOVERNMENT CONTRACTS, COST ACCOUNTING STANDARDS, 4-21 (1986).

⁹Bruce Constr. v. United States, 163 Ct.Cl. 97, 100, 324 F. 2d 516 (1963). Accord J. F. Shea Co. v. United States, 10 Cl. Ct. 620, 627 (1986); Varo, Inc. v. United States, 212 Ct. Cl. 432, 443 (1977); Nager Elec. v. United States, 194 Ct.Cl. 835, 852-53 (1971); American Int'l Mfg., ASBCA 25816, 84-3 BCA 17,698 at 88,285; Jacobson Constr., VABCA 1811, 34-3 BCA 17563 at 87,498; Holtzen Constr., AGBCA 413, 75-2 BCA 11378 at 54,160; Space Age Eng'g, ASBCA 18600, 74-2 BCA 10869 at 51,722-23; Historical Servs., DOT CAB 72-8, 72-8A, 72-2 BCA 9582 at 44,789.

¹⁰Coley Properties v. United States, 219 Ct.Cl. 227, 236 (1979), Ed Goetz Painting Co., DOT CAB 1168, 83-1 BCA 16134 at 80,142.

¹¹Bruce Constr. v. United States, 163 Ct.Cl. 97, 100, 324 F.2d 516 (1963).

Since the purpose underlying such adjustments is to safeguard the contractor against increased costs engendered by the modification, it appears patent that the measure of damages cannot be the value received by the Government, but must be more closely related to and contingent upon the altered position in which the contractor finds himself by reason of the modification.

Accord Xplo Corp., DOTCAB 1409, 86-3 BCA 19280 at 97,471.

¹²General Ry. Signal Co., ENG BCA 3970, 84-1 BCA 17014 at 84,728, 84,730; American Elec., ASBCA 15152, 73-1 BCA 9787 at 45,733.

¹³See J. F. Shea Co. v. United States, 10 Cl. Ct. 620, 627 (1986); Pacific Architects & Eng'rs v. United States, 203 Ct.Cl. 499, 508, 491 F.2d 734 (1974); Dick & Kirkman, Inc., VABCA 1545, 1581, 84-3 BCA 17662 at 88,082; Atlantic Elec., GSBKA 6061, 83-1 BCA 16484 at 81,956; Massman Constr., ENG BCA 3660, 81-1 BCA 15049 at 74,453; Holtzen Constr., AGBCA 413, 75-2 BCA 11378 at 54,160; Space Age Eng'g, ASBCA 18600, 74-2 BCA 10869 at 51,722; Itek Corp., Applied Technology Div., ASBCA 13528, 71-1 BCA 8906 at 41,393.

¹⁴Dick & Kirkman, Inc., VABCA 1545, 1581, 84-3 BCA 17662 at 88,082. Accord R & E Elecs., VABCA 2227, 85-3 BCA 18316 at 91,895; Unicom Sys., ASBCA 29468, 84-3 BCA 17675 at 88,164; Armanda, Inc., ASBCA 27354, 27385, 84-3 BCA 17,694 at 88,242; Fluor Utah, Inc., IBCA 1068-4-75, 81-1 BCA 14876 at 73,521; Massman Constr., ENG BCA 3660, 81-1 BCA 15049 at 74,453; E. Arthur Higgins, AGBCA 76-128, 79-2 BCA 14050 at 69,066; Celesco Indus., ASBCA 22251, 79-1 BCA 13604 at 66,683; G & M Elec. Contractors, GSBKA 4771, 78-1 BCA 13452 at 65,733; Ocean Technology, ASBCA 21363, 78-1 BCA 13204 at 64,586; Franchi Constr., ASBCA 16735, 74-2 BCA 10654 at 50,598; Warren Painting, ASBCA 18456, 74-2 BCA 10834 at 51,531; Frank Biscoe Co., GSBKA 345, 73-1 BCA 10008 at 46,958; Historical Servs., DOT CAB 72-8, 72-2 BCA 9582 at 44,789; Varo, Inc., ASBCA 15000, 72-2 BCA 9717 at 45,356; Bregman Constr., ASBCA 15020, 72-1 BCA 9411 at 43,718; Hensel Phelps Constr., ASBCA 15142, 71-1 BCA 8796 at 40,872; Itek Corp., Applied Technology Div., ASBCA 13528, 13848, 71-1 BCA 8906 at 41,393.

¹⁵Platt and Sons, ASBCA 20349, 75-2 BCA 11511 at 54,912.

¹⁶Under both the Suspension of Work clause (FAR 52.249-10) and the Government Delay of Work clause (FAR 52.212-15) contractors are allowed adjustments rather than equitable adjustments.

¹⁷The "short form" termination clause for fixed price contracts of \$100,000 or less is at FAR 52.249-1. The "long form" termination clause, mandatory for fixed price contracts

of over \$100,0000, is at FAR 52.249-2. The termination clause for cost reimbursement contracts is at FAR 52.249-6.

¹⁸Cibinic & Nash, *supra* note 1, at 773.

¹⁹FAR 49.201(a) (emphasis added).

²⁰FAR 31.205-42(b).

²¹FAR 31.205-42(g).

²²FAR 52.249-2.

²³J. BULLOCH, D. KELLER, & C. VLASHO, ACCOUNTANTS' COST HANDBOOK, A GUIDE FOR MANAGEMENT ACCOUNTING, 19.12-13 (3d ed. 1983). See also J. FREMGEN & S. LIAO, THE ALLOCATION OF CORPORATE INDIRECT COSTS, 19-20 (1981):

[T]he costs that are relevant to pricing are opportunity costs. . . . [In economic theory] the role of costs in pricing . . . is to determine supply, both for the market as a whole and for the individual seller, not to determine prices directly. In pure competition, prices are established by the interaction of supply and demand in the market. The individual seller has no discretion; it accepts the market price as given. If a single firm has costs below normal for the industry, its advantage will be short-lived, as competitors will promptly bid up the price for whatever factor of production gives the firm its cost advantage. Conversely, if one firm's costs are above normal for the industry, it must either reduce them or eventually go out of business. It cannot raise its own prices to compensate for higher costs.

[In an imperfectly competitive market] product differentiation permits a seller to manipulate its price within some range without fear of retaliation by competitors or loss of customers to them. Within this range of price discretion, the individual firm's costs may be used to establish the price. Exactly how cost helps to determine price is not entirely clear, however. Often, costs are used to establish initial target prices, but management may then deviate from those prices to cope with market forces or with other considerations, such as the danger of increased competition in the long run or the threat of regulation.

²⁴Department of Defense, ARMED SERVICES PRICING MANUAL, 10-1 (1986) [hereinafter ASPM].

²⁵Professor Charles T. Horngren defines cost as "resources sacrificed or forgone to achieve a specific objective." C. HORNGREN, COST ACCOUNTING, A MANAGERIAL EMPHASIS, 21 (5th ed. 1982).

²⁶FAR Part 31, Contract Cost Principles and Procedures.

²⁷L. ANDERSON, ACCOUNTING FOR GOVERNMENT CONTRACTS, COST ACCOUNTING STANDARDS, (1986); J. BEDINGFIELD & L. ROSEN, GOVERNMENT CONTRACT ACCOUNTING, (2d ed.1985); M. RISHE, GOVERNMENT CONTRACT COSTS, (1st ed. 1984); P. TRUEGER, ACCOUNTING GUIDE FOR GOVERNMENT CONTRACTS, (8th ed. 1985).

²⁸The CAS were issued by the Cost Accounting Standards Board (CASB) created by P.L. 91-379 in January 1971. The purpose of the CASB was to achieve uniform and consistent cost accounting standards for national defense contracts and rules and regulations implementing those cost accounting standards. P.L. 91-379(g), (h). Although the CASB ceased to exist in 1980 because Congress failed to fund it, between the years 1971 and 1980, the CASB promulgated 19 standards which are mandatory for most negotiated contracts over \$100,000.

²⁹FAR 30.201-1(b) exempts the following categories of contracts and subcontracts, among others, from all CAS requirements:

- (1) Sealed bid contracts.
- (2) Negotiated contracts and subcontracts not in excess of \$100,000.
- (3) Contracts and subcontracts with small businesses.
- (4) Contracts and subcontracts in which the price is set by law or regulation.
- (5) Contracts and subcontracts when the price is based on established catalog or market prices of commercial items sold in substantial quantities to the general public.
- (6) Contracts and subcontracts of \$500,000 or less if the business unit is not currently performing any national defense CAS-covered contracts.
- (7) Nondefense contracts awarded based on adequate price competition.

(8) Nondefense contracts and subcontracts awarded to business units that are not currently performing any CAS-covered national defense contracts.

(9) Contracts awarded to labor surplus area concerns pursuant to a labor surplus area set-aside.

(10) Contracts and subcontracts to be executed and performed entirely outside the United States, its territories, and possessions.

³⁰FAR 30.202-1(b). The contractor must disclose information sufficient to "(1) establish[] a clear understanding of the cost accounting practices the contractor intends to follow, (2) defin[e] costs charged directly to contracts and disclos[e] the methods used to make such charges, and (3) delineat[e] the contractor's methods of distinguishing direct costs from indirect costs and the basis for allocating costs to contracts." Department of Defense, DEFENSE CONTRACT AUDIT MANUAL, 8-202a (1983).

³¹For contracts subject to full CAS coverage, FAR Subpart 30.3 is incorporated by reference into the contract. See FAR 52.230-3, Cost Accounting Standards clause. For contracts subject to modified CAS coverage, the contractor is required to comply with the provisions of FAR 30.401 and 30.402. See FAR 52.230-5, Disclosure and Consistency of Cost Accounting Practices clause.

³²Department of Defense, DEFENSE CONTRACT AUDIT MANUAL, 8-202a (1983).

³³FAR 30.408.

³⁴FAR 30.409.

³⁵FAR 30.411.

³⁶FAR 30.413.

³⁷FAR 30.414.

³⁸FAR 30.415.

³⁹FAR 30.416.

⁴⁰FAR 30.420.

⁴¹*Id.*

⁴²FAR Part 31, Contract Cost Principles and Procedure.

⁴³FAR 31.103(b)(3).

⁴⁴FAR 31.103(b)(6).

⁴⁵FAR 31.201-1.

⁴⁶*Id.*

⁴⁷See Bedingfield & Rosen, *supra* note 27, at 5-2; Bulloch, Keller, & Vlasho, *supra* note 23, at 21.8; P. FISCHER & W. FRANK, *COST ACCOUNTING, THEORY AND APPLICATION*, 6 (1985). This is true even though the accounting system may be in compliance with Generally Accepted Accounting Principles (GAAP).

⁴⁸Bedingfield & Rosen, *supra* note 27, at 14-18.

⁴⁹*Id.* See e.g., National Mfg., ASBCA 18806, 74-1 BCA 10580 at 50,150.

⁵⁰Bedingfield & Rosen, *supra* note 27, at 14-18. See e.g. Leopold Constr., ASBCA 23,705, 81-2 BCA 15277. Because contractor's accounting practices did not segregate costs in a way that permitted actual costs of the change to be determined, the contractor failed to carry its burden of proof with respect to additional costs. Therefore, its recovery was limited to the Government's estimate of increased cost.

⁵¹ASPM, *supra* note 24, at 3-8.

⁵²A "cost objective" is an activity for which a separate measurement of cost is desired. Horngren, *supra* note 25, at 58. FAR 31.001 defines "cost objective" as a "function, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc."

⁵³FAR 31.001.

⁵⁴FAR 31.201-4.

⁵⁵FAR 31.201-1.

⁵⁶Bedingfield & Rosen, *supra* note 27, at 5-5. Anderson, *supra* note 27, at 9-3, defines a direct cost in terms of traceability. "If the thing (or object), whether tangible or intangible, represented by a cost is traceable to individual units of product produced or services performed, the cost is a direct cost of the product or service; otherwise, the cost is an indirect cost."

⁵⁷FAR 31.202(a). A "final cost objective" is a cost objective that has allocated to it both direct and indirect costs and, in the contractor's accumulation system, is one of the final accumulation points. FAR 31.001. A cost can be "specifically identified" with a particular final cost objective if (1) the beneficial or causal relationship between the costs incurrence and the final cost objective is clear and exclusive, (2) the amount of the cost is readily and economically measurable, and (3) all other costs incurred for the same purpose in like circumstances can also be identified specifically with final cost objectives and accounted for as direct costs. See Boeing Co., ASBCA 19224, 79-1 BCA 13708 at 67,248-49. Note that the FAR's definition of "direct cost" differs from the commonly accepted cost accounting definition of direct cost in its emphasis on "final cost objectives." Bedingfield & Rosen, *supra* note 27, beginning at 8-8, sharply criticize the FAR's definition for failing to recognize that all costs can be direct costs at some level; for example, "[a]ll costs are direct costs of a company taken as a whole." As a practical matter, however, the definitional difference appears unimportant.

⁵⁸FAR 31.202(a).

⁵⁹Bulloch, Keller, & Vlasho, *supra* note 23, at 1.13.

⁶⁰*Id.*

⁶¹FAR 31.203(a) defines "indirect cost" as any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. Anderson, *supra* note 27, at 9-3 to 9-4, defines an indirect cost as one which economically cannot be traced to individual units of product or services. For Government contracts, the focal point of cost accumulation is by contract rather than by product. Therefore, for Government contract purposes, an indirect cost

is one which cannot be economically traced to an individual contract.

⁶²FAR 31.203(a).

⁶³FAR 31.203(b):

Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative (G&A) expenses are separately grouped.

⁶⁴Bulloch, Keller, & Vlasho, *supra* note 23, at 1.13.

⁶⁵R. NASH & J. CIBINIC, *FEDERAL PROCUREMENT LAW*, VOLUME II, 1464 (3d ed. 1980). See FAR 31.202(a). Anderson, *supra* note 27, at 9-3, explains the desirability of direct costing as follows:

For purposes of cost reimbursement (in government contract cost accounting) and for general accuracy in attaching costs to a given product or service, it is desirable to classify costs as direct rather than indirect. That is because direct costs are charged directly to individual units, whereas indirect costs are distributed in a roundabout, and hence usually less accurate, process.

⁶⁶FAR 31.202(a). See *Dynalelectron v. United States*, 545 F.2d 736, 738 (1976), (legal fees specifically identifiable with a commercial venture were direct costs of that venture and were not includable in G&A).

⁶⁷See *FMC Corp.*, ASBCA 30130, 87-2 BCA 19791, at 100,137-38; *Peter Kiewit Sons' Co.*, ENG BCA 4742, 85-1 BCA 17911 at 89,708; *Foster Constr.*, DOTCAB 71-16, 73-1 BCA 9869, where in upholding a contractor's treatment of certain costs as direct costs the board stated at 46,150-51:

First, as a general rule, cost accounting procedures seek to identify in the most direct possible way the cost of a particular item or a work activity. In other words, the general rule is to first segregate out all charges that can be identified

with the specific objective in mind, leaving as indirect charges only those where the identification cannot be made. Indirect costs, therefore, are residuals. Such a stance is not only in accord with generally accepted accounting principles, it is also consistent with the definitions embodied in [FAR 31.202(a)].

Secondly, where the essential task is to determine the amount of an equitable adjustment flowing from a changed condition, the terms of the contract clauses call for a finding of the 'increase or decrease in the cost of . . . performance of the contract' In our view, this necessarily implies a preference for costing out a change or changed condition in the most direct manner possible. The alternative to this approach which consists of lumping all disputed costs into an overhead pool for allocation hardly seems to be either a rational or a fair method of arriving at equitable adjustment for specific claims.

⁶⁸Nash & Cibinic, *supra* note 65, at 1457.

⁶⁹*Id.* at 1464-65. Anderson, *supra* note 27, at 9-4 comments: "it may not be economically feasible to charge the cost directly--the costs of record keeping required for direct charging may exceed the benefits."

⁷⁰FAR 31.202(b). CAS 402.50(e).

⁷¹See Bedingfield & Rosen, *supra* note 27, at 5-6; J. FULTZ, OVERHEAD, WHAT IT IS AND HOW IT WORKS, 3 (1980); Bulloch, Keller, & Vlasho, *supra* note 23, at 1-13; M. Rishe, *supra* note 27, at 11-2. See also Tera Advanced Servs., GSBICA 6713-NRC, 85-2 BCA 17940 at 89,888; Starks Contracting, VACAB 1339, 79-2 BCA 1448 at 68,848; Switlik Parachute Co., ASBCA 18024, 75-1 BCA 11434 at 54,443. Note, however, that the nature of a cost will determine whether it will be classified as direct or indirect when:

- (1) indirect costs are applied to a change as a standard percentage markup on direct costs. See *infra* note 199 and accompanying text.
- (2) the contract has a Changes clause that defines indirect costs as including supervisory costs, small tools, etc. See *infra* note 204 and accompanying text.
- (3) the parties for purposes of the adjustment have negotiated an indirect cost rate. See e.g., F. F. Slocomb Corp., ASBCA 20169, 76-2 BCA 12071 at 57,946.

⁷²Bedingfield & Rosen, *supra* note 27, at 5-6.

⁷³Fultz, *supra* note 71, at 3.

⁷⁴In *American International Manufacturing*, ASBCA 25816, 84-3 BCA 17698 at 88,286, the Government argued that guard services benefited more than just the contractor's manufacturing operations and therefore should be transferred from the service overhead pool to the much larger G&A pool. The board found against the Government on the facts, but the case demonstrates that inclusion of a cost in a cost pool that is not distributed to all cost objectives benefiting from the cost will result in over allocation to the cost objectives to which the cost is distributed. Note, it is the grouping (rather than the individual costs elements in the grouping) which must bear a beneficial or equitable relationship with the several cost objectives. See *Cyro-Sonics, Inc.*, ASBCA 13219, 70-1 BCA 13219 at 38,654.

⁷⁵FAR 31.203(b).

⁷⁶See Anderson, *supra* note 27, at 9-14.

Pooling of costs for distribution to final cost objectives is an averaging process. All averaging, however, results in a loss of accuracy. Thus, in determining the number of cost pools to be maintained, contractors generally weigh the desired accuracy in cost allocation against the cost of obtaining that accuracy.

See also Bedingfield & Rosen, *supra* note 27, at 5-22 to 5-26; Rishe, *supra* note 27, at 11-15.

⁷⁷Rishe, *supra* note 27, at 11-15. The expense and inconvenience of establishing a separate pool is indicated in *Savoy Construction Co.*, ASBCA 21218, 80-1 BCA 14392. Here the contractor (believing it was spending a disproportionate amount of time on owner-directed changed work) attempted to establish a separate home office overhead pool for owner-directed changes. Its home office personnel (in seven departments: management, operations, estimating, purchasing, accounting, payroll, and filing and mailing) kept records of their time for one month placing particular emphasis on time spent processing owner-directed changes. Because the method used to establish the pool was not uniform and systematic the contractor did not meet its heavy burden and, therefore,

was unable to establish this as a separate pool for purposes of pricing adjustments.

⁷⁸Horngren, *supra* note 25, at 515.

⁷⁹FAR 31.203(b).

⁸⁰Obviously, a contractor's cost accounting system must be capable of determining costs for purposes of progress payments. However, the precision needed to justify progress payments is significantly less than that needed to justify compensation under an equitable adjustment or a termination settlement.

⁸¹FAR 31.203(b).

⁸²Bedingfield & Rosen, *supra* note 27, at 8-26; ASPM, *supra* note 24, at 6-5 to 6-14.

⁸³See e.g., *infra* Chapter 2, Parts I.E and F. The standard markup for indirect costs and clauses limiting recovery of indirect costs both use the term "overhead" as a synonym for indirect costs in general.

⁸⁴See TOUCHE ROSS AND CO., GOVERNMENT COST RECOVERY, 36-A (1986).

⁸⁵*Id.* See also FAR 30.410-30; Anderson, *supra* note 27, at 9-6.2.

⁸⁶A separate CAS has been established for G&A. See FAR 30.410. Another CAS covers "indirect cost." See FAR 30.418. Note that the CAS apply only to CAS-covered contracts.

⁸⁷See FAR 30.403. A home office is "[a]n office responsible for managing two or more, but not necessarily all, segments of an organization." FAR 30.403(a)(2). See also Braude and Kovars, *Extended Home Office Overhead*, Constr. Briefings, No. 84-6, 1-2 (June 1984).

Home office overhead costs usually include (1) rent and depreciation, (2) licenses and fees, (3) property taxes, (4) utilities and telephone, (5) salaries or fees of directors, officers, management and clerical personnel, (6) auto and travel, (7) data processing, (8) insurance and bond premiums, (9) legal and accounting expenses, (10) interest, (11) office supplies and photo-copying, and (12) other costs

incidental to the general administration of the company.

⁸⁸See FAR 30.403-40.

⁸⁹Horngren, *supra* note 25, at 478-79.

⁹⁰FAR 31.203(b) (emphasis added). See e.g., Elliot Machine Works, ASBCA 16135, 72-2 BCA 9501, where the contractor unsuccessfully argued that the total cost of labor and materials should be used as the distribution base for manufacturing overhead. The Board held that direct labor was the proper base stating:

It is obvious that a job which requires 1,000 hours of manufacturing labor benefits more from the manufacturing plant and should bear a larger share of the manufacturing overhead than another job involving the same labor and material costs and requires only 100 hours of manufacturing labor. Considering the nature of appellant's operations, where there was a wide variance in the amount of labor required on the jobs having the same amount of total labor and material costs, it is obvious that direct manufacturing labor is a more accurate measure of the extent of use of the manufacturing plant than is total labor and material costs.

Id. at 44,270 (emphasis added).

⁹¹Rishe, *supra* note 27, at 11-17 (emphasis added).

⁹²This does not mean that each and every cost element in a cost pool must proportionately benefit each of the cost objectives to which the pool is distributed, but that the cost grouping as a whole must be distributed to cost objectives in proportion to the benefits received. See American Elec., ASBCA 16635, 76-2 BCA 12151 at 58495; McDonnell Douglas Corp., ASBCA 12639, 69-2 BCA 8063 at 37,496; Daystrom Instrument, Div. of Daystrom, ASBCA 3438, 58-2 BCA 2050 at 8634.

⁹³See FAR 31.201-4.

⁹⁴Note that FAR 31.202(b) provides that distribution bases "should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the

several cost objectives." (emphasis added) No mention is made of any other distribution base. By implication, it is only when allocation cannot be made on a relative benefit basis that use of another basis is permissible.

⁹⁵See Fultz, *supra* note 71, at 53; Horngren, *supra* note 25, at 516-17.

⁹⁶See FAR 30.403-40, Allocation of Home Office Expenses to Segments; FAR 30.410-40, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives; and FAR 30.418, Allocation of Direct and Indirect Costs.

⁹⁷FAR 31.203(b) requires that cost be allocated on the basis of benefits accruing to the several cost objectives. All cost objectives benefiting from a cost must be allocated a proportionate share of the cost. A cost of sales base is objectionable because it does not consider the total activity of the business unit during the period--only sales activity. Thus, all cost objectives that benefit from incurrence of a cost may not receive a proportionate allocation. See e.g., Westinghouse Elec., ASBCA 25787, 85-1 BCA 17,910 at 89,676-81 (stating that CAS 410 "ruled out" use of the cost of sales method of G&A allocation for CAS-covered contracts); AC Elecs. Div., General Motors Corp., ASBCA 14388, 72-2 BCA 9558 at 44,521; Daystrom Instrument, Div of Daystrom, ASBCA 3438, 58-1 BCA 1588 at 5,760, *aff'd on motion for reconsid.* 58-2 BCA 2050, "The cost-of-sales basis of allocation of G&A expense is proper only if . . . there is no great disparity in the amount of inventory between the beginning and the end of the allocation period." See Curtiss-Wright Corp., Wright Aeronautical Div., ASBCA 9032, 65-2 BCA 4960 at 23,146. The Government questioned use of a cost of sales method of allocation because it did not allocate any G&A costs to a company-sponsored research and development program. The Board did not reach this issue because the amount involved was de minimis. See R. W. Borrowdale Co., ASBCA 11362, 69-1 BCA 7564 at 35,036-37; Litton Sys., ASBCA 10395, 66-1 BCA 5599. But see American Int'l Mfg., ASBCA 25816, 84-3 BCA 17698 at 88,288, where the Government made no objection to the contractor's use of a cost of sales base for allocation of G&A.

⁹⁸FAR 31.204(e).

⁹⁹Rishe, *supra* note 27, at 14-7.

¹⁰⁰FAR 31.204(e). Under FAR 30.302(a), "full CAS coverage" applies to contractor business units that:

(1) Receive a single national defense CAS-covered contract award of \$10 million or more; (2) Received \$10 million or more in national defense CAS-covered contract awards during its preceding cost accounting period; or (3) Received less than \$10 million in national defense CAS-covered contract awards during its preceding cost accounting period but such awards were 10 percent or more of total sales.

¹⁰¹FAR 30.406-40(a). CAS 406 permits use of a base period of less than one year for (1) indirect functions existing for less than one year, and for (2) the transitional period created by a change in the contractor's fiscal year.

¹⁰²FAR 30.302(b) (1):

Modified, rather than full CAS coverage may be applied to a covered contract of less than \$10 million awarded to a business unit that received less than \$10 million in national defense CAS-covered contracts in the immediately preceding cost accounting period if the sum of such awards was less than 10 percent of the business unit's total sales during that period.

¹⁰³FAR 31.203(e). A base period shorter than one year is permissible only when it equitably allocates cost. In *American Scientific, Corp.*, IBCA 576-666, 67-2 BCA 6670 at 30,955, the Board, acknowledged that use of a period shorter than one year was a possibility under FPR and then denied its use commenting, "the base period selected should be representative of normal operations, and should be long enough to protect against significant variations from the overall situation of the company." (citations omitted).

¹⁰⁴See *Art Metal U.S.A.*, GSBGA 5898, 83-2 BCA 16881, where the board decided that the fourth quarter of the contractor's fiscal year should be the distribution base. The Government objected to inclusion of "year-end" charges in the fourth quarter cost grouping when the charges benefited the entire year--not just the fourth quarter. The Board agreed and eliminated year end charges from the cost grouping.

¹⁰⁵See *Daystrom Instrument, Div. of Daystrom*, ASBCA 3438, 58-1 BCA 1588 at 5,761, *aff'd on motion for reconsid.* 58-2 BCA 2050 where the 45 month base period selected by the

contractor was disallowed because it did not accurately allocate G&A expenses to the operations which generated such expenses. But see *National Manufacturing*, ASBCA 18806, 74-1 BCA 10580 at 50,160, where the Board found it more reasonable to use a four year, composite, G&A rate in pricing a defective specification claim than the annualized rate argued for by the Government because direct costs were low and overhead high during the initial years of the contract.

¹⁰⁶See *Penberthy Electromelt Int'l v. United States*, 11 Cl. Ct. 307, 319 (1986).

¹⁰⁷FAR 42.701.

¹⁰⁸See *Bulloch, Keller, & Vlasho*, *supra* note 23, at 17.12-13. See also *Fischer & Frank*, *supra* note 47, at 27-31.

¹⁰⁹*Bulloch, Keller, & Vlasho*, *supra* note 23, at 17.12.

¹¹⁰*Id.* at 17.13.

¹¹¹*Id.*

¹¹²J. ADRIAN, *CONSTRUCTION ACCOUNTING*, 257 (2d ed. 1986).

¹¹³ASPM, *supra* note 24, at 6-19.

¹¹⁴*Bulloch, Keller, & Vlasho*, *supra* note 23, at 17.13.

¹¹⁵Also called mixed costs. See *Fischer & Frank*, *supra* note 47, at 30.

¹¹⁶*Bulloch, Keller, & Vlasho*, *supra* note 23, at 17.13.

¹¹⁷*Fremgen & Liao*, *supra* note 23, at 18-23.

¹¹⁸See ASPM, *supra* note 24, at 6-22; *Bulloch, Keller, & Vlasho*, *supra* note 23, at 17.17-.20; *Fischer & Frank*, *supra* note 47, at 63-79.

¹¹⁹*Bulloch, Keller, & Vlasho*, *supra* note 23, at 18.16 to 18.17. "Contribution margin is equal to sales minus variable expenses." *Horngren*, *supra* note 25, at 45.

¹²⁰Horngren, *supra* note 25, at 45. The formula used to calculate the breakeven point is: fixed expense divided by unit contribution margin.

¹²¹"Period costs" are listed in the income statement in their entirety as expenses of the period . . . and are not charged to the work-in-process inventory and not traced through the finished-goods inventory into cost of sales." Bulloch, Keller, & Vlasho, *supra* note 23, at 5.40.

¹²²*See e.g.*, Bedingfield & Rosen *supra* note 27, at 5-15; Horngren, *supra* note 25, at 52; S. MOSCOVE, G. CROWNSHIELD, K. GORMAN, *COST ACCOUNTING WITH MANAGERIAL APPLICATIONS*, Chapter 12 (5th ed. 1985).

¹²³"Full Costing" is the term used by Melvin Rishe in his book, *Government Contract Costs*, *supra* note 27, at 11-3, and by Touche Ross in their book, *GOVERNMENT CONTRACT COST RECOVERY*, 35-A (1986). The term "full cost" also is used by Professor Horngren to refer to a product costing system where all costs are distributed to products. *See* Horngren, *supra* note 25, at 369. It is used by other accounting experts as well. *See* Ford Aerospace and Communications, Corp., ASBCA 23833, 83-2 BCA 16813 at 83,615.

¹²⁴American Institute of Certified Accountants, *Accounting Research Bulletin* no. 43.

¹²⁵Bedingfield & Rosen, *supra* note 27, at 5-15 (emphasis added).

¹²⁶Fremgen & Liao, *supra* note 23, at 18-19.

¹²⁷*Id.*

¹²⁸Rishe, *supra* note 27, at 11-3.

¹²⁹Anderson, *supra* note 27, at 9-6.

In the commercial environment, a product is assigned the direct costs of materials and labor, and a portion of the overhead costs of manufacturing; general and administrative (G&A) expenses and any other indirect costs are charged to the period in which they were incurred. A government contract on the other hand, includes all indirect costs of the contractor

including a portion of G&A expense; no costs are charged to the period in which they were incurred.

¹³⁰More properly stated, all costs are allocated to "contracts." For Government contract purposes, the focal point of cost accumulation is the contract rather than a "product." See Anderson, *supra* note 27, at 9-6.

¹³¹Rishe, *supra* note 27, at 11-3.

¹³²Bedingfield & Rosen, *supra* note 27, at 5-15.

¹³³*Id.* at 5-16.

¹³⁴FAR 31.201-6(a).

¹³⁵FAR 31.201-1.

¹³⁶FAR 31.201-2.

¹³⁷See *supra* Chapter 1, Parts IV.B. and IV.F.

¹³⁸FAR 31.201-3.

¹³⁹*Id.* In determining whether a specific cost is reasonable, the contracting officer considers:

- (a) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;
- (b) The restraints or requirements imposed by such factors as generally accepted sound business practices, arm's-length bargaining, Federal and State laws and regulations, and contract terms and specifications;
- (c) The action that a prudent business person, considering responsibilities to the owners of the business, employees, customers, the Government, and the public at large would take under the circumstances; and
- (d) Any significant deviations from the established practices of the contractor that may unjustifiably increase the contract costs.

Id.

140FAC 84-26 (July 30, 1987) amends FAR 31.201-3 as follows: (1) "no presumption of reasonableness shall be attached to the incurrence of costs by a contractor," and (2) upon challenge "the burden of proof shall be upon the contractor to establish that such cost is reasonable."

141Bruce Constr. v. United States, 324 F.2d 516 (1963). Inroads on the rule set forth by *Bruce Construction* were made by Section 933 of the Defense Procurement Improvement Act of 1985 (P.L. 99-145) which placed the burden of proof on the contractor to establish that disputed costs were reasonable. The statute did not, however, expressly state that actual costs were not to be "presumed reasonable" and applied only to proving the reasonableness of indirect costs and to DOD. See Gov't Contr., Vol. 28, No. 6 (March 17, 1986).

142Franklin W. Peters and Assoc., ICBA 762-1-69, 71-1 BCA 8615.

143Stanley Aviation Corp., ASBCA 12292, 68-2 BCA 7081 at 32,788.

144ASPM, *supra* note 24, at 6-19.

The 90 percent can describe a manufacturing company that still relies on hand labor and hand tools with no automatic machines. As a result, its direct labor base, against which its overhead is measured, is high because of the greater amount of time needed to perform the tasks. At the same time, overhead is less than might otherwise be the case because it includes little or no costs for depreciation of machinery.

Id.

145"Although the GAAP's do not appear in a single, definitive, codified form, most public auditors agree on the majority of the items they 'generally accept' as accounting principles." Bedingfield & Rosen, *supra* note 27, at 4-11.

146FAR 31.201-2(a)(3).

147Bedingfield & Rosen, *supra* note 27, at 4-4. See Celesco Indus., ASBCA 22402, 80-1 BCA 14271 at 70,297. "Such principles have been developed for asset valuation and income measurement, and 'are not cost accounting principles' as such, although cost accounting principles [may] evolve out of

them." *Id.* (citations omitted). See also Wolf Research and Dev., ASBCA 10913, 68-2 BCA 7222 at 33,546.

¹⁴⁸See F. ALSTON, F. JOHNSON, M. WORTHINGTON, L. GOLDSTEIN, & F. DEVITO, *CONTRACTING WITH THE FEDERAL GOVERNMENT*, 161 (1984) [hereinafter Alston].

¹⁴⁹Trueger, *supra* note 27, at 430-31. See also Gould Defense Sys., ASBCA 24881, 83-2 BCA 16676 at 82,390.

¹⁵⁰Trueger, *supra* note 27, at 431. See Boeing Co., ASBCA 11866, 69-2 BCA 7898 at 36,753. See also Daystrom Instrument, Div. of Daystrom, ASBCA 3438, 58-1 BCA 1588 at 5756, *aff'd on motion for reconsid.*, 58-2 BCA 2050. "[I]t should be recognized that many public accountants and many well-managed business firms follow accounting principles and practices that do not conform to the A.I.A. bulletins, and such accounting principles and practices must also be recognized as being "generally accepted."

¹⁵¹FAR 31.109.

¹⁵²FAR 31.109(h).

¹⁵³FAR 31.109(b).

¹⁵⁴FAR 31.109(c).

¹⁵⁵Limiting clauses are often included in construction contracts. Agencies that commonly use such clauses include the General Services Administration, the Postal Service, the Veterans Administration, and the Navy. See Cibinic & Nash, *supra* note 1, at 519-23.

¹⁵⁶See Samuel S. Barnett Co., GSBGA 4855, 80-1 BCA 14355 at 70,768-69; Jack Picoult, GSBGA 2351, 69-1 BCA 7678, *aff'd on motion for reconsid.*, 69-2 BCA 7820.

¹⁵⁷See Central Mechanical, Inc., DOT CAB 1234, 83-2 BCA 16642 at 82,753; ACS Constr., ASBCA 23471, 79-2 BCA 23471 at 69,388 and 69,390.

¹⁵⁸See *infra* Chapter 2, Part I.F.

¹⁵⁹FAR 31.205.

¹⁶⁰FAR 31.201-6.

¹⁶¹FAR 31.201-6(c).

¹⁶²FAR 31.201-6(a). "A directly associated cost is any cost which is generated solely as a result of incurring another cost and which would not have been incurred had the other cost not been incurred." *Id.*

¹⁶³See e.g., J.W. Bateson Co., ASBCA 22337, 78-2 BCA 13523 at 66,265.

¹⁶⁴FAR 31.201-6(d) provides the following exception:

If a directly associated cost is included in a cost pool which is allocated over a base that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs.

¹⁶⁵*Id.* If a fragmented distribution base were used for allocation purposes, the excluded portion of the base would not absorb the overhead costs it purportedly generated or benefited from. For example, assume that certain direct material costs, having been unreasonably incurred, were deemed unallowable and assume that the distribution base for material overhead is direct material cost. The purchase of the unallowable material generated the same material acquisition and handling effort as did any other purchase. Its removal from the distribution base establishes a distribution base in the amount it would have been had the unallowable costs not been incurred, but leaves in the overhead pool for distribution the increased material overhead costs generated by the unreasonable purchase.

¹⁶⁶Because the unallowable cost portion of the distribution base is not linked to a cost objective, the indirect cost grouping will not be totally distributed to the several cost groupings. The remaining portion of the indirect cost grouping is in effect allocated to the unallowable costs. In sum, although not a cost objective, unallowable costs in the distribution base are treated like one.

¹⁶⁷FAR 31.203(c) provides:

Once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the distribution of G&A costs, all items that would properly be part of the cost input base, whether allowable or unallowable, shall be included in the base and bear their pro rata share of G&A costs.

¹⁶⁸Kenyon Magnetics, Inc., GSBGA 5264, 80-2 BCA 14624 at 72,135 (allowing as a direct cost a fixed percentage of the salary of contractor's president and clerical staff, telephone and postage charges, and travel costs).

¹⁶⁹*Id.*

¹⁷⁰The distribution base normally used in pricing changes is direct labor dollars or another direct cost of the change. As noted in chapter 1, distribution bases other than direct costs are occasionally used. See *supra* note 95 and accompanying text.

¹⁷¹See Cal-Tom Constr., VABCA 85-3 BCA18211 at 91,407 (the equitable adjustment was a lump sum figure including all markups); E. Arthur Higgins, AGBCA 76-128, 79-2 BCA 14050 at 69,067; Datametrics, Inc., ASBCA 16086 BCA 74-2 10742 at 51,103 (jury verdict did not separately show the amount allocated to individual cost elements such as G&A); Webber Constructors, IBCA 72-6-8, 69-2 BCA 7895; Geris, Inc., DOT CAB 67-6, 69-1 BCA 7450 at 34,577-78.

¹⁷²Estimates "if they are supported by detailed substantiating data or are reasonably based on verifiable experience" form an acceptable starting point for computing an equitable adjustment. Celesco Indus., ASBCA 21928, 81-2 BCA 15260 at 75,547-48.

¹⁷³A projected overhead rate is developed through a five step process: (1) select a base period, (2) estimate production volume for the period, (3) estimate indirect expenses for the period, (4) estimate the distribution base for the period, and (5) divide estimated indirect expenses by the estimated distribution base. See Fultz, *supra* note 71, at 32.

174 See Alston, *supra* note 148, at 367.

175 *Id.* See also Cibinic & Nash, *supra* note 1, at 513-14.

176 See *infra* Chapter 2, Part II.

177 See *American Electric*, ASBCA 15152, 73-1 BCA 9787 at 45,730, where the Board went so far as to relieve the Government from an earlier stipulation that overhead rates were 123.3% when actual rates were 172.6%. See also *National Mfg.*, ASBCA 18806, 74-1 BCA 10580 at 50,157; *Elliot Machine Works*, ASBCA 16135, 72-2 BCA 9501 at 44,269; *Keco Indus.*, ASBCA 15061, 72-2 BCA 9575 at 44716. But see *infra* note 190, discussion of CRF-A Joint Venture of Cemco and R. F. Communications; and Massman Constr.

178 See e.g., CRF-A Joint Venture of Cemco and R. F. Communications, ASBCA 17340, 76-1 BCA 11857 at 56,803-04; *American Elec.*, ASBCA 15152, 73-1 BCA 9787 at 45,730; *Keco Indus.*, ASBCA 15061, 72-2 BCA 9575 at 44716.

179 FAR 15.809(a).

180 FAR 15.809(b).

181 FAR 15.809(c).

182 Assuming that the contractor uses direct cost as its distribution base. If a distribution base other than direct cost is used, the indirect cost portion of the adjustment is determined by multiplying the contractor's indirect cost rate by the increase in that distribution base.

183 See e.g., *Stewart Avionics*, ASBCA 23161, 78-1 BCA 13130 (because the contractor was unable to prove in which fiscal year the retrofit took place the Board applied the lower of the overhead rates for the two years--270% as compared to 661%).

184 A change deleting work, particularly if major, may be treated as a partial termination for convenience rather than a change. If so, settlement would be handled under the Terminations for Convenience clause rather than under the Changes clause. See Cibinic and Nash, *supra* note 1, at 784. See generally *Ideker, Inc.*, ENG BCA 4389, 87-3 BCA 20145 at 101,974.

185 Assuming that the contractor's distribution base is direct cost. If a distribution base other than direct cost is used, the indirect cost portion of the downward equitable adjustment is determined by multiplying the contractor's indirect cost rate by the estimated decrease in that distribution base.

186 See e.g., *Fordel Films West*, ASBCA 23071, 79-2 BCA 13913 at 68,298.

187 See *Algernon Blair, Inc.*, ASBCA 10738, 65-2 BCA 5127 at 24,141, where the contractor claimed that deductive changes caused additional expenses--preparing estimates, securing prices and subcontractor proposals, preparing and submitting proposals for the changes and additional contract administration. It argued therefore, that its overhead was not reduced by the deductive change. The Board rejected this reasoning but stated in dicta that if a contractor could show "special circumstances" the credit due the Government might be reduced. See also *Sun Elec. Corp.*, ASBCA 13031, 70-2 BCA 8371. Here, the contractor unsuccessfully argued that the Government was not due a credit for material handling charges because the costs of ordering the material and cancelling the order had already been incurred. The Board reasoned:

The ordering for material purchases, in the first place, represents only a beginning of company operations for which, upon the whole, costs are covered under the burden and G&A expense; and without some particular showing, routine cancellation could not be supposed as adding expense sufficient or so substantial as to bring all costs incurred in respect of appellant's partial cancellation into any approximation with the whole distributive cost share (\$5,216.71), which amounts to very nearly one-third the direct cost.

Id. at 38,395.

188 See *Pacific Contractors*, ENG BCA PCC-29, 79-2 BCA 13998 at 68,720.

189 See *Dawson Construction*, GSBGA 5364, 82-1 BCA 15701 at 77,661 where the Board stated "deductive and additive changes must be priced in the manner dictated by the Equitable Adjustments provision of the contract's general conditions, that is, by applying the markups to the net increases in

direct costs." See also *J. F. Shea Co. v. United States*, 10 Cl. Ct. 620, 628 (1986); *Glover Constr.*, ASBCA 29194, 85-2 BCA 18093 at 90,809-10; *J. Harvy Crow*, GSBKA 41423, 75-2 BCA 11423 at 54,390-91.

190 *Id.* But See *CRF-A Joint Venture of Cemco and R. F. Communications*, ASBCA 17340, 76-1 BCA 11857 at 56,803-04, where different indirect costs rates were used to determine indirect costs of the deleted and the added work. The board held that when the "plus-and-minus changes net out on the plus side" current overhead rates are used to price both--but when the change is a net deductive change it is proper to price the additive portion of the change using the contractor's higher actual overhead rates and the deductive portion of the change using the contractor's lower projected rates. The Board reasoned that the deletion reduced the quantity of the contractor's work, thereby increasing the contractor's overhead rates and that the Government, who had the burden of proof with respect to the deductive portion of the change, had failed to prove that the contractor's projected rates were not reasonable. The reasoning of this decision has not been applied in any subsequent cases. See also *Massman Construction*, ENG BCA 3660, 81-1 BCA 15049 at 74,454-55, where indirect costs of the substituted work were determined using the contractor's bid rather than actual indirect cost rate. The event necessitating the equitable adjustment was the Government's substitution of a more expensive cement. The Board reasoned that since the contractor's original bid did not adequately provide for recovery of indirect cost it was necessary to use the original bid's indirect cost rate to preserve the loss position of the contractor. The Board was incorrect in holding that application of the originally bid indirect cost rate to the net increase in direct cost was necessary to preserve the contractor's profit/loss position on the unchanged work. The profit/loss position on the unchanged work is unaffected by the indirect cost rate applied to the net increase or decrease in direct costs caused by a substitution. The Board simply forced the contractor to perform the net change at a loss.

191 See e.g., *Flores Drilling and Pump Co.*, AGBCA 82-204-3, 83-1 BCA 16200. The contractor claimed overhead at a rate of 114%. Because the contractor did not submit evidence substantiating that rate the Board used a standard overhead rate (15%). See also *Forest Rd. Constr.*, AGBCA 84-221-3, 85-2 BCA 18160 at 91,188; *ACS Constr.*, ASBCA 23471, 79-2 BCA 23471 at 69,390. The contractor "not know[ing] what its

actual overhead was doing" claimed overhead at 10%; its most recent year's corporate overhead rate was 16%.

¹⁹²See C. N. Flagg & Co., ASBCA 26444, 84-1 BCA 17120 (holding that the contractor's actual indirect cost rate of 10.3% should be used rather than 15% standard markup used to price change orders prior to the actual rate being available); Brezina Constr., IBCA 757-1-69, 73-1 BCA 10195 at 48,062 (holding that the contractor's actual indirect cost rate of 6.5% should be used rather than the 10% standard markup used to price change orders prior to the audited rate being available). See also Arnold M. Diamond, Inc., ASBCA 20667, 77-2 BCA 12769. The contractor originally proposed a 10% overhead rate for a change. The proposal was not accepted. After a DCAA audit found the contractor's overhead rate to be 30.5% the contractor revised its claim accordingly. The Board awarded overhead at the 30.5% rate. See also *supra* note 177.

¹⁹³See *American Federal Contractors*, PSBCA 1359, 87-1 BCA 19595 at 99,119, where the board stated, "A contractor, upon a proper showing with specific evidence can recover overhead costs beyond the standard allowance."

¹⁹⁴*Id.*

¹⁹⁵See Flores Drilling and Pump Co., AGBCA 82-204-3, 83-1 BCA 16200 at 80,487; Urban Plumbing and Heating Co., ASBCA 9831, 71-2 BCA 8980 at 41,744.

¹⁹⁶Cases in which a 10% rate was adopted include: Salem Eng'g and Constr. v. United States, 2 Cl. Ct. 803, 809 (1983); *American Fed. Contractors*, PSBCA 1359, 87-1 BCA 19595 at 99,119; *Arctic Corner*, ASBCA 29545, 86-3 BCA 19304 at 97,605-06; *KenCom, Inc.*, GSBGA 7717, 86-2 BCA 18900 at 95,341; *Steven E. Jawitz*, ASBCA 31164, 86-1 BCA 18620 at 93,555 (allowed both field office overhead of 10% and a separate charge for G&A of 3%); *3A/Magnolia-Ju*, IBCA 1885, 85-3 BCA 18202 at 91,370; *R & E Elecs.*, VABCA 2227, 85-3 BCA 18316 at 91,897; *Glover Constr.*, ASBCA 29194, 85-2 BCA 18093 at 90,810; *Forest Rd. Constr.*, AGBCA 84-221-3, 85-2 BCA 18160 at 91,188; *Fred A. Arnold, Inc.*, ASBCA 20150, 84-3 BCA 17624; *ACS Constr.*, ASBCA 23471, 79-2 BCA 23471 at 69,390; *Alps Corp.*, ASBCA 19632, 75-1 BCA 11260 at 53,672; *Detweiler Bros.* ASBCA 17897, 74-2 BCA 10858 at 51,644; *Cecil Pruitt, Inc.*, ASBCA 18344, 73-2 BCA 10213 at 48,150-51; *Varo, Inc.*, ASBCA 15000, 72-2 BCA 9717 at 45,360; *Bregman Constr.*, ASBCA 15020, 72-1 BCA 9411 at 43,718; *Framlau Corp.*, ASBCA 15516,

71-2 BCA 9145 at 43298; Ray D. Bolander Co., IBCA 331, 70-1 BCA 8200 at 38,133-34; Algernon Blair, Inc., ASBCA 10738, 65-2 BCA 5127 at 24,141.

Cases in which a 15% rate was adopted include: Hoyer Constr., ASBCA 31241, 86-1 BCA 18619 at 93,553; Long Floor Co., ASBCA 29319, 84-3 BCA 17688 at 88,203; Flores Drilling and Pump Co., ASBCA 82-204-3, 83-1 BCA 16200; Warren Painting Co., ASBCA 18456, 74-2 BCA 10834 at 51,525, 51,533; Foster Constr., DOT CAB 71-16, 73-1 BCA 9869 at 46,152; Cen-Vi-Ro of Texas, IBCA 718-5-68, 73-1 BCA 9903 at 46,411; P.M.W. Constr., ASBCA 11121, 66-2 BCA 5901 at 27,371.

¹⁹⁷See Urban Plumbing and Heating Co., ASBCA 9831, 71-2 BCA 8980 at 41,745 (the Board lowered the contractor's recovery of overhead to 13% after stating that 15% was standard); Trans-Eastern Constructors, Inc., ASBCA 13612, 70-2 BCA 8453 at 39,325.

¹⁹⁸Trans-Eastern Constructors, Inc., ASBCA 13612, 70-2 BCA 8453 at 39,325.

¹⁹⁹In *American Federal Contractors*, PSBCA 1359, 87-1 BCA 19595 at 99,119, the board held that:

To recover labor costs of supervisory employees . . . a contractor must show that the officers performed other than normal supervisory duties and devoted themselves exclusively to the work directed by the modification. See *Bell v. United States*, 404 F.2d 975, 982-83 (Ct. Cl. 1968). In this instance, Appellant has not demonstrated that the officers actually directed the labor, or that the coordination, negotiation and inspectional activities were unusual. Thus, there is no basis for considering the costs as direct labor costs, or as additional overhead for the modification.

See also Hoyer Constr., ASBCA 31241, 86-1 BCA 18619 at 93,553 (construction manager, project manager, and secretary's salaries were not allowable as direct costs but included in 15% markup for overhead); ACS Constr., ASBCA 23471, 79-2 BCA 23471 at 69,390 (supervisor's salary was not allowable as a direct cost but was included in the 10% markup); Fred A. Arnold, Inc., ASBCA 20150, 84-3 BCA 17624 at 87,838 ("impact labor costs" to review change, orient crew to change, prepare estimate, negotiate change, and perform clerical work were not allowed as direct costs--"including such costs in the

direct cost base while using the standard . . . markup rates, would result in a duplicative recovery of such costs"); A. Geris, Inc., DOT CAB 67-6, 69-1 BCA 7450 at 34,577, (clerical expenses were held to be a minor general expense includable in the 15% markup for overhead and profit).

200 For over 20 years the General Services Administration (GSA) has used a clause limiting overhead recovery. Most of the cases testing the validity of clauses limiting overhead recovery, even today, involve GSA contracts. The Veterans Administration and the Postal Service also use a limiting clause.

201 Such terms have been interpreted as permitting a contractor to compound overhead and profit and thus recover a combined 21% for overhead and profit. See Tutor-Saliba-Parini, PSBCA 1201, 87-1 BCA 19775 at 100,079.

202 The current GSA and Veterans Administration clauses are set out in Appendix 1.

203 See Santa Fe Eng'rs v. United States, 801 F.2d 379 (Fed Cir. 1986) (10% limitation included delay overhead on the change so contractor was precluded from making a separate claim for this item); Pipe Installation Co., VABCA 2157, 86-3 BCA 19055 at 96248 (the Changes clause defined overhead to include insurance, field and office supervisors and assistants, incidental job burden, and general home office expense and effectively limited contractor's recovery to 10% of direct costs); Jack Cooper Constr., VABCA 1663, 84-3 BCA 17703 at 88,341-42; Gulf-Tex Constr., VACAB 1341, 83-1 BCA 16355 at 81,279-80; Colton Constr., VABCA 1574, 83-1 BCA 16220 at 80,601; West Land Builders, VABCA 1664, 83-1 BCA 16235 (successfully limiting recovery of extended overhead); Biscayne Constr., GSBGA 3827, 74-1 BCA 10637 at 50,514; J. Harvy Crow, GSBGA 41423, 75-2 BCA 11423 at 54,389-91; Elec. & Missile Facilities, GSBGA 2306, 69-2 BCA 7787 (contractor was denied increased field office overhead and home office overhead on unchanged work--10% commission fully compensated contractor); Jack Picoult, GSBGA 2351, 69-1 BCA 7678, *aff'd on motion for reconsid.*, 69-2 BCA 7820 (successfully limiting the number of markups on subcontracted work). But see Jervis B. Webb, PSBCA 420, 78-2 BCA 13544 where the Board allowed the contractor to recover engineering overhead at 105%, shop overhead at 303%, and installation overhead at 25% rather than at the 10% rate specified in the contract. A long history of prior contracts disclosed the parties' intent that the clause would not be applied. More importantly, the

Government received the contractor's proposal for the change before the work was performed and failed to notify the contractor of the Government's intent to strictly apply the overhead limitations. The contractor was prejudiced in that had it known of the Government's intent it could have subcontracted the work instead of performing the work itself.

²⁰⁴See e.g., Spruill Realty/Constr., ASBCA 28650, 85-3 BCA 18395 (disallowing sole proprietor's time as a direct cost); J.C. Edwards Contracting and Eng'g, VABCA 1047, 85-2 BCA 18064 (disallowing supervisory costs as a direct cost); Rysean Corp., VABCA 2021, 84-2 BCA 17505 (disallowing supervision as a direct cost); Dawson Constr., GSBCA 5364, 82-1 BCA 15701 at 77,662 (although the contractor's job-site staff spent 80% of its time on the change order, it could not be charged as a direct cost because the contract defined indirect costs to include job-site staff); Samuel S. Barnett Co., GSBCA 4855, 80-1 BCA 14355 (disallowing supervisory costs as direct costs); Pyramid Constr., GSBCA 4882, 78-1 BCA 13215, *aff'd on motion for reconsid.*, 78-2 BCA 13422; Detweiler Bros., ASBCA 17897, 74-2 BCA 10858 at 51644 (disallowing telephone calls and executive time as direct costs); James P. Purvis, GSBCA 905, 74-2 BCA 10959, at 52,144-45 (disallowing excess supervision, and utilities as direct costs); Jack Picoult Constr., GSBCA 3516, 72-2 BCA 9621, *aff'd*, 207 Ct.Cl. 1052 (1975) (contractor unsuccessfully argued that supervisory work performed by its first tier subcontractor on labor and materials furnished by a second tier subcontractor were direct costs); Blake Constr., GSBCA 2908, 70-1 BCA 8095, *aff'd on motion for reconsid.*, 70-1 BCA 8258, at 37,609. But see Tele-Security, Inc., GSBCA 7037, 84-2 BCA 17360. Here, the contractor was permitted to charge directly costs of administering a deductive change order; specifically, 167 hours of its president's time, 10 hours of its job-site supervisor's time and \$343.44 in telephone charges plus a markup for G&A on those costs. The Board reasoned that these costs could be specifically identified with a particular contract and thus could be charged directly. Had the Changes clause defined overhead to include home office expense, the contractor probably would not have recovered these costs as direct costs.

²⁰⁵The converse is true as well. When volume decreases, the amount of fixed cost per unit of construction increases.

206 Calculation of indirect cost rate at 12 million units

Variable indirect costs (12 million units X \$1 per unit)	\$12 million
Fixed indirect costs	<u>\$20 million</u>
Total indirect costs	\$32 million
Direct costs (12 million units X \$2 per unit)	\$24 million
Overhead rate (\$32 million / \$24 million)	133%

207 Calculation of the amount of over absorbed indirect cost

1. Amount of indirect cost assigned to the change at the originally projected overhead rate:

Direct costs (2 million units X \$2 per unit)	\$4 million
Originally projected indirect cost rate	<u>150%</u>
Amount of indirect cost assignable to the change	\$6 million

2. Amount of indirect cost properly assignable to the change:

Variable indirect cost (2 million units X \$1.00 per unit)	\$2 million
Fixed indirect cost per unit (\$20 million/12 million units)	\$1.67
Fixed indirect cost allocable to the change (\$1.67 X 2 million units)	\$3.33 million
Indirect cost assignable to change (\$2 million + \$3.33 million)	\$5.33 million

3. Amount of over absorbed indirect cost:

(\$6 million - \$5.33 million)	\$.67 million
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208 Generally, a contractor is expected to prove its costs through the best evidence available. Thus, "[t]he preferred method for establishing the amount of an adjustment is through the introduction of the actual cost data for the additional work" (as opposed to estimates). *Cibinic & Nash*, *supra* note 1, at 462. See also *ACS Constr.*, ASBCA 33550, 87-1 BCA 19660 at 99,550; *American Elec.*, ASBCA 15152, 73-1 BCA 9787 at 45,733.

209 *Cibinic & Nash*, *supra* note 1, at 514.

210 Assuming such costs are not unallowable.

211 *Bruce Constr. v United States*, 163 Ct.Cl. 97, 100, 324 F.2d 516 (1963); *J. F. Shea Co. v. United States*, 10 Cl.Ct.

620, 627 (1986); *Varo, Inc. v. United States*, 212 Ct.Cl. 432, 443 (1977); *Nager Elec. v. United States*, 194 Ct.Cl. 835, 852-53 (1971).

212ACS Constr., ASBCA 33550, 87-1 BCA 19660 at 99,550.

213Bulloch, Keller, & Vlasho, *supra* note 23, at 19.8, point out that "[i]n estimating the impact of a change in activity on departmental overhead, only the variable component is considered. The fixed overhead does not change within the relevant range."

214M. Rishe, *supra* note 27, at 6-15 (1st ed. 1984), citing *Coley Properties v. United States*, 593 F.2d 380 (Ct.Cl.1979). See *supra* notes 15 and 16, the cases cited therein, and accompanying text.

215Under direct costing only variable manufacturing costs are allocated to products. To properly keep a contractor whole, all variable costs, not just manufacturing costs, have to be recovered. Therefore, "direct costing" as used in this section is a method of costing that allocates all variable costs to cost objectives. The concepts of full and direct costing are discussed at *supra* Chapter 1, Parts VI.B. and VI.C.

216A profit rate of 10% is often treated as a standard. See *Cibinic & Nash*, *supra* note 1, at 518.

217Assuming of course that the change did not prevent the contractor from obtaining work priced at a level permitting recovery of fixed indirect costs.

218No revenue is generated by unused capacity. If job opportunities are available that will not allow recovery of "full" cost but will generate revenue in excess of variable cost, the contractor can maximize short term profit by taking advantage of these opportunities.

219L. ANDERSON, ACCOUNTING FOR GOVERNMENT CONTRACTS, COST ACCOUNTING STANDARDS (1986); J. BEDINGFIELD & L. ROSEN, GOVERNMENT CONTRACT ACCOUNTING (2d ed.1985); M. RISHE, GOVERNMENT CONTRACT COSTS (1st ed. 1984); P. TRUEGER, ACCOUNTING GUIDE FOR GOVERNMENT CONTRACTS (8th ed. 1985).

220A "cost reimbursement" type contract is often used when a fixed price contract is impracticable because performance

costs cannot be estimated accurately. Under a cost reimbursement type contract, the Government reimburses the contractor for its full costs of performance. The contractor is then paid a separate fee for profit. See J. CIBINIC & R. NASH, FORMATION OF GOVERNMENT CONTRACTS, (1986) Chapter 7, Sections III and IV.

221 FAR 31.103(b).

222 FAR 31.203(b).

223 FAR 31.203(c).

224 Trueger, *supra* note 27, at 95-96.

225 *Id.* at 96.

Note 226 begins on page 207.

226 Whether or not the Government will compensate a contractor for its increased costs of performing a fixed price contract depends upon the cause of the delay. In general terms, delay is compensable if it is caused by the Government and not compensable otherwise. See Cibinic and Nash, *supra* note 1, Chapter 6. Where both parties contribute to the delay, the contractor cannot recover damages unless the contractor can establish its delay apart from that attributable to the Government. See Volk Constr., IBCA 1419-1-81, 87-3 BCA 19968, at 101,102 (citing Klingensmith v. United States, 731 F.2d 805, 809 (C.A.F.C. 1984)).

227 Indirect costs are usually determined by multiplying the direct costs of performance by a contractor's actual or projected indirect cost rate or by a standard mark-up for overhead. See *supra* Chapter 2, Part I.

228 When performance is resumed, direct costs may be increased as a result of the delay. But during the delay itself, direct costs are incurred at a reduced level. The reason is that most direct costs are variable in nature. When a direct cost is itself a fixed cost, it will continue to be incurred at normal rates during the delay. An example of a fixed, direct cost is a facility leased and used exclusively for one contract.

229 Bedingfield and Rosen, *supra* note 27, at 14-27. Stated differently, "'Unabsorbed overhead' exists when the direct cost base is not large enough to absorb the fixed overhead . . . at the contractor's 'normal' absorption rate." Irwin, *The Return of Eichleay: Is It Here to Stay? Part II*, Constr. Claims Monthly, Vol. 6, No. 7, at 1 (July 1984). See also Kurz and Root Co., ASBCA 14665, 72-2 BCA 9552 at 44,841; Allied Materials and Equip., ASBCA 17318, 72-2 BCA 11150 at 53,089.

230 See e.g., Kent and Walters, *Recovering Indirect Costs*, Constr. Briefings, No. 80-6, at 2 (Nov. 1980). After stating that "[t]he distinction between the terms 'extended overhead' and 'unabsorbed overhead' has become blurred over the years" and criticizing the boards' inconsistent use of the terms, Kent and Walters incorrectly define the concepts:

The conceptual difference between the two terms may be stated as follows: Unabsorbed overhead focuses on the period of suspension during contract performance--and

the additional costs generated during that period. Extended overhead focuses on the extended period of contract performance at the end of a project, which results from delays during performance--and the additional costs created by extension of the contract period.

This definition does not accurately describe the injury suffered by the contractor and therefore is meaningless. The conceptual difference between the two terms is that unabsorbed overhead focuses on the amount by which the base used for distributing fixed indirect costs is reduced whereas extended overhead focuses on the benefit received by the Government in the form of increased home office effort due to extension of the period of contract performance.

²³¹See *Capital Elec.*, GSBICA 5316, 83-2 BCA 16548 at 82,311, *rev'd on other grounds*, 729 F.2d 743 (C.A.F.C. 1984).

²³²For example, in a recent opinion the GSBICA stated, "the terms 'extended' and 'unabsorbed' overhead are often used virtually interchangeably, as in the court's opinion in *Capital Electric. . . .*" *Stevenson Assoc.*, GSBICA 6573, 86-3 BCA 19071 at 96,350.

²³³See e.g., *Capital Elec.*, GSBICA 5316, 83-2 BCA 16548 at 82,311, *rev'd on other grounds*, 729 F.2d 743 (C.A.F.C. 1984); McGovern, *Compensating Contractors for Delay-Related Costs*, Cont. Mgmt., 13 (Oct. 1984).

²³⁴See *supra* note 226. But see *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,369 (holding that when a contract is terminated for convenience, entitlement to unabsorbed overhead for pre-termination delay is not contingent on whether or not the delay was caused by the Government).

²³⁵See *Allied Materials and Equip.*, ASBCA 17318, 75-1 BCA 11150.

The claim for unabsorbed burden expense bears no direct relationship to the direct and indirect expenses incurred on a particular contract, but arises because of a decrease in the allocability of the burdens [of] a particular contract due to a reduction in the direct cost base in that contract during a period of disruption and delay and consequently causes

other work in the plant to sustain an increased allocation of the burdens over what would have been experienced if there had been no delay and disruption.

Id. at 53,089.

²³⁶See R. W. Contracting, ASBCA 24627, 84-2 BCA 17302 at 86,219; Switlik Parachute Co., ASBCA 18024, 75-1 BCA 11434 at 54,445:

Such under-absorption of [fixed overhead or G&A] as support for a delay claim cannot exist unless productive facilities are tied up on the contract, or at least held available for it and not otherwise used for a longer period than they would have been absent the delay; or unless available direct labor personnel are under-utilized due to the delay. (citing Therm-Air Mfg., ASBCA 15842, 74-2 BCA 10818 at 51,441-42).

²³⁷See Capital Elec. v. United States, 729 F. 2d 743, 746 (C.A.F.C. 1984).

²³⁸*Id.*

²³⁹See e.g., Excavation-Constr., ENG BCA 3858, 83-1 BCA 16338 at 81,209. See also *Fred R. Comb Co. v. United States*, 103 Cl. Ct. 174, 184 (1945):

If as in this case, the delay which postpones the completion of existing work occurs at the very beginning of that work it would be an invitation to the merest guess work to require the contractor to give evidence as to what he would have done next after this work was completed, if it had been completed at an earlier time when he knew it would not be completed. . . . We think that the Government, having breached its contract, has no right to say, in effect, that its breach shall go uncompensated unless the contractor proves, with precision, what is usually not susceptible of such proof.

²⁴⁰However, recovery of *extended* overhead may be permissible and is discussed *infra* notes 242-66 and accompanying text.

²⁴¹See Nash & Cibinic, *supra* note 65, at 1409.

242Net under absorption of overhead occurs when delay shifts work into a later, more active accounting period. Because production is greater in the later accounting period, the delayed work will absorb less fixed indirect cost per unit of production than it would have in the earlier period. In contrast, net over absorption of overhead occurs when delay shifts work into a later, less active accounting period. Because the volume of work is less in the later accounting period, the delayed work will absorb more fixed indirect cost per unit of production than it would have in the earlier period. For a criticism of the concept of over absorbed overhead see Walters, *Capital Electric - Eichleay's Swan Song*, 19 Pub. Cont. News1. 3, at 12 (Winter 1984).

243See *Capital Elec.*, GSBCE 5316, 83-2 BCA 16548 at 82,311, *rev'd on other grounds*, 729 F. 2d 743 (C.A.F.C. 1984).

244A claim for unabsorbed overhead, could be framed as a claim for extended overhead as well. However because entitlement to extended overhead has not yet been authoritatively decided, an assumption is made that a contractor would attempt to recover unabsorbed overhead rather than extended overhead if entitlement to unabsorbed overhead could be proven.

245The Claims Court in *Savoy Construction v. United States*, 2 Cl. Ct. 338,341-42, *rev'd*, unpublished decision, Appeal No. 83-1029 (C. A. F. C. 1984), explained it this way:

[T]he concept of awarding additional home office overhead on a per diem basis simply because the performance time on a project has been extended presents logical difficulties. As noted, this overhead cost is not related to contract performance. The cost will continue regardless of when any one contract is completed. Having a contract in progress for an additional period of time does not necessarily increase or decrease home office costs. Only if an extended performance period on one contract served to preclude the receipt of new revenue would the contractor actually suffer a loss of sums otherwise available to offset its continuing home office overhead expense.

246Richard Walters, correctly recognizing the difference between extended overhead and unabsorbed overhead, argues

that a contractor should recover extended overhead because the Government benefits from the extended home office efforts and that the Government should not get a "free ride" in the period of contract extension.

Because no provision is made in a contractor's bid for home office efforts beyond the original contract performance period, the contractor is entitled to recover all the home office overhead costs properly assignable to that contract during the period of extended performance. It should not matter that most of those costs are fixed and would theoretically have been incurred by the contractor even absent the government delay. There is no doubt that the government is benefited by those extended home office costs, and there is no reason why the government should not be liable for an adjustment consonant with the benefit received based upon a fair proportion of a contractor's home office costs.

Capital Electric--Eichleay's Swan Song, 19 Pub. Cont. News1. 3, at 13 (Winter 1984). *Accord Ernstrom and Essler, Beyond the Eichleay Formula: Resurrecting Home Office Overhead Claims*, The Constr. Law., Vol. 3, No.1 (Winter 1982). "[I]n most cases, the contractor will not actually experience a significant net increase in home office overhead expense. Instead, there is a disproportionate commitment of relatively fixed home office resources and expenses. . . to the delayed project to the prejudice of the contractor's other projects and opportunities." *Id.* at 8.

²⁴⁷Despite comments to the contrary by some commentators. See e.g., Braude and Kovars, *Extended Home Office Overhead*, Constr. Briefings, No. 84-6, at 3 (June 1984). "The law is well established that extended home office overhead is a recoverable element of delay damages." (citing *Capital Elec. and Savoy Constr.*) *Accord* Constr. Law Adviser, (No. 6, June 1984). The Federal Circuit Court of Appeals in *Capital Electric v. United States*, 729 F. 2d 743, 744 (C.A.F.C. 1984), did not decide whether extended overhead was recoverable--it sidestepped the issue. It found that Capital Electric had introduced un rebutted evidence of its inability to take on substitute work during the various delay periods. Thus, entitlement to unabsorbed overhead was established, eliminating the need to decide whether 'extended overhead' was recoverable.

²⁴⁸See e.g., *Capital Elec.*, GSBICA 5316, 83-2 BCA 16548 at 82,311, *rev'd on other grounds*, 729 F. 2d 743 (C.A.F.C. 1984). Here, in a very thorough and scholarly opinion, the GSBICA attempted to distinguish unabsorbed and extended overhead and show why extended overhead was not recoverable. While the Board easily defined unabsorbed overhead, it was unable to define the basis of extended overhead. Its comments were limited to the statement that extended overhead has as its premise that extending the performance period will increase overhead costs.

²⁴⁹See *Bruce Constr. v. United States*, 163 Ct.Cl. 97,100 (1963).

Equitable adjustments in this context are simply corrective actions utilized to keep a contractor whole when the Government modifies a contract. Since the purpose underlying such adjustments is to safeguard the contractor against increased costs engendered by the modification, it appears patent that the measure of damages cannot be the value received by the Government, but must be more closely related to and contingent upon the altered position in which the contractor finds himself by reason of the modification.

Id. See also *supra* notes 15-16 and the cases cited therein.

²⁵⁰"[C]ourts have yet to develop a rationale to support a recovery, absent an increase in overhead expenditures or postponement of future work." Note, *Home Office Overhead for Construction Delays*, 17 Ga. L. Rev. 761, 774 n.28 (1983). See also *A.C.E.S., INC.*, ASBCA 21417, 79-1 BCA 13809 at 67,721; *Fischbach & Moore Int'l*, ASBCA 18146, 77-1 BCA 12300 at 59,224, "It is axiomatic that a contractor asserting a claim against the Government must prove not only that it incurred the additional costs making up its claim but also that such costs would not have been incurred but for the Government action."

²⁵¹See e.g., *B. J. Lucarelli & Co.*, ASBCA 8768, 65-1 BCA 4655, at 22,257, where the Board stated:

There is no evidence that the [delay] caused any increase in appellant's home office expense or that it in any way affected appellant's capability of taking on other work. In the absence of evidence that the

[delay] caused any increase in home office expense, we do not even reach the question of how to compute the amount of the increase.

Accord Ricway, Inc., ASBCA 30056, 86-3 BCA 19139, at 96,741; Ricway, Inc. ASBCA 29983, 86-2 BCA 18841 at 94,955 (application of the *Eichleay* formula is not automatic every time a suspension of work occurs--a *prima facie* showing that the contractor had to stand by is required under *Capital Electric*); Vepco, Inc., ASBCA 26993, 84-2 BCA 17255; Bromley Contracting, DOT CAB 1284, 83-2 BCA 17233; R. W. Contracting, ASBCA 24627, 84-2 BCA 17302 at 86,223 (no decrease in the base over which appellant's overhead was allocated); Seckinger & Co., ASBCA 26233, 82-1 BCA 15793, at 78,230 (failed to show that any other work was burdened with an increased home office expense rate); Therm-Air Mfg., ASBCA 15842, 74-2 BCA 10818, at 51,441-42 (no evidence of under utilization of available production labor for which the Government was responsible).

²⁵²Extended overhead is used here to mean recovery of fixed indirect costs in the absence of any showing that the contractor's distribution base was reduced by a Government-caused contract extension.

²⁵³Able Contracting, ASBCA 27411, 85-2 BCA 18017 at 90,385. Accord Charles W. Schroyer, Inc., ASBCA 21859, 78-1 BCA 21859 at 66,227 (Government's contention that the contractor was able to use its work force elsewhere was considered irrelevant).

²⁵⁴See *Capital Elec. v. United States*, 729 F.2d 743, 746 (C.A.F.C. 1984).

²⁵⁵But see *supra* note 231.

²⁵⁶See e.g., *Fortec Constructors v. United States*, 8 Ct. Cl. 490, 499 (1985). See also *George Hyman Constr.*, ENG BCA 4541, 85-1 BCA 17847. Here the Board found the contractor was entitled to extended overhead, stating:

The manifest unfairness of keeping a contractor engaged on, or liable to perform, a job but postponing or extending his performance well beyond what he had a right to expect and upon which he bid, demands a means of compensating him for this costs of operating his

home office during such extended period. *Eichleay* represents such a method. *Id.* at 89,354.

This is the basis normally used to justify entitlement to extended overhead absent proof of a reduced distribution base justifying entitlement to unabsorbed overhead. The case was tried *de novo* in the Federal District Court. See *George Hyman Constr. v. Washington Area Transit*, 621 F.Supp. 898 (D.C.D.C. 1985). The court first commented that the D.C. Circuit Court of Appeals did not recognize extended overhead as a basis of recovery and then found that the delay had prevented the contractor from taking on additional work, thus entitling it to recovery of unabsorbed overhead.

²⁵⁷See *B.J. Lucarelli & Co.*, ASBCA 8768, 65-1 BCA 4655 at 22,257; *R.W. Contracting*, ASBCA 24627, 84-2 BCA 17302 at 86,223 (decrease in the base over which appellant's overhead is calculated is a prerequisite); *Seckinger & Co.*, ASBCA 26233, 82-1 BCA 15793 at 78,230; *L & H Constr.*, ASBCA 23620, 81-1 BCA 14823 at 73,60-61; *Savoy Constr.*, ASBCA 21218, 80-1 BCA 14392, *motion for reconsid. denied*, 80-2 BCA 14724, *aff'd*, 2 Cl.Ct. 338 (1983), *rev'd*, unpublished opinion, Appeal No. 83-1029 (C.A.F.C.1984); *Therm-Air Mfg. Co.*, ASBCA 15842, 74-2 BCA 10818, at 51,441-42. *Charles W. Schroyer, Inc.*, ASBCA 21859, 78-1 BCA 21859 at 66,227, is the only case that permits recovery.

²⁵⁸See *Savoy Constr.*, ASBCA 21218, 80-1 BCA 14392, *motion for reconsid. denied*, 80-2 BCA 14724, *aff'd*, 2 Cl.Ct. 338 (1983), *rev'd*, unpublished opinion, Appeal No. 83-1029 (C.A.F.C.1984). Although the reversal was unpublished and of no precedential value, the Federal Circuit Court of Appeals did overrule a decision where both the GSBGA and Claims Court held extended overhead was not recoverable.

²⁵⁹*G.S. and L. Mechanical and Constr.*, DOT CAB 1640, 86-3 BCA 19026 at 96,094-95. However, the Board then found that the delay had kept the contractor from beginning performance of a Navy contract it had been awarded. Thus, the Board's endorsement of extended overhead was not necessary for contractor's recovery--entitlement to unabsorbed had been shown.

²⁶⁰See e.g., *Kent and Walters, Recovering Indirect Costs*, Constr. Briefings, No. 80-6, at 2 (Nov. 1980). "The concept of 'extended overhead' is unique to construction contracting. . . . By comparison 'unabsorbed overhead' is a manufacturing

accounting concept." *Accord Braude and Kovars, Extended Home Office Overhead*, Constr. Briefings, No. 84-6, at 2 (June 1984). "Extended overhead is unique to construction contracting, while unabsorbed overhead is only appropriate to manufacturing." *Accord Capital Elec.*, GSBICA 5316, 83-2 BCA 16548 at 82,311, *rev'd on other grounds*, 729 F. 2d 743 (C.A.F.C. 1984). "Extended overhead is a concept unique to construction contracting. It has as its premise . . . that extending the performance period will increase overhead costs." *Accord Recovery of Extended Home Office Overhead-- The Latest Chapter*, Constr. L. Advisor (June 1984).

261 See R.G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012.

Where it is practicable for the contractor to shift its work force productively and efficiently to other contracts, part or all of the otherwise unabsorbed indirect costs will be allocable to direct costs expended in the performance of the other work. Accordingly, good faith, successful reassignment of qualified workers during periods of suspended work effectively mitigates the contractor's damages and generally reduces the unabsorbed indirect cost recovery.

Id. at 96,027.

262 See Kent and Walters, *supra* note 260, at 12. "A delay, or suspension of work, generally does not influence [a construction contractor's] decision to take on additional projects because--unlike a manufacturing company--a construction company's ability to take on new work is limited only by its bonding capacity and the availability of its managerial personnel." *Accord Braude and Kovars, supra* note 260, at 2. "[T]he construction contractor simply opens up a new 'plant' at each jobsite on which he works. . . ."

263 See *e.g.*, Stephenson Assocs., GSBICA 6573, 86-3 BCA 19071.

264 As distinguished from extended overhead.

265 performance of the substituted work maintains the integrity of the distribution base so there is no unabsorbed overhead. In contrast, the construction contractor's distribution base is reduced by the delay resulting in unabsorbed overhead in that period. However, this unabsorbed

overhead will be offset by overabsorbed overhead in the following period. See *supra* Chapter 3, Part II.B.2.

²⁶⁶Entitlement to recovery of any "net" unabsorbed overhead is discussed at *supra* note 242 and accompanying text.

²⁶⁷FAR 52.212-12. The Suspension of Work clause is a mandatory clause for fixed-price construction contracts. It permits the contracting officer to suspend work for a reasonable period of time. Under the Suspension of Work clause, a contractor is entitled to recover only its increased costs of performance (no profit) for the unreasonable portion of any delay. See FAR 12.502.

²⁶⁸FAR 52.212-13. The Stop-Work-Order clause is an optional clause for supply, services, and research and development contracts. It permits the contracting officer to order the contractor to stop contract performance. Under the Stop-Work-Order clause, a contractor is entitled to an equitable adjustment for its increased costs caused by the stop work order. See FAR 12.503.

²⁶⁹FAR 52.212-15. The Government Delay of Work clause is a mandatory clause for most fixed price supply contracts and optional for fixed price service contracts. It allows compensation for delays and interruptions in the contract work caused by the acts, or failures to act, of the contracting officer. Under the Government Delay of Work clause, a contractor is entitled to recover only its increased costs of performance caused by the delay or interruption (no profit). See FAR 12.504.

²⁷⁰FAR 52.243-4. The Changes clause is a mandatory clause for fixed-price contracts. It permits the contracting officer to make changes in the work within the scope of the contract at any time. Under the Changes clause, a contractor is entitled to an equitable adjustment for its increased costs of performance caused by the change. See FAR 43.201(a).

²⁷¹FAR 52.236-2. The Differing Site Conditions clause is a mandatory clause for fixed-price construction contracts when the contract amount is expected to exceed the small purchase limitation. It provides an equitable adjustment whenever subsurface or latent conditions at a site differ materially from those indicated in the contract or when the contractor encounters unknown physical conditions at the site, of an

unusual nature, that differ materially from those ordinarily encountered in work of the type specified in the contract. Under the Differing Site Conditions clause, a contractor is entitled to an equitable adjustment for its increased costs of performance caused by the differing site condition. See FAR 36.502.

²⁷²FAR 52.249-2. The Termination for Convenience clause is a mandatory clause for all fixed-price contracts. See *supra* note 17. Under the Termination for Convenience clause, contractors can recover pre-termination unabsorbed overhead plus reasonable profit. See *infra* notes 421-428 and accompanying text. They also can recover an equitable adjustment for the increased costs of performing the unterminated portion of the contract caused by the termination. Recovery of unabsorbed overhead under partially terminated contracts is discussed *infra* notes 547-554 and accompanying text.

²⁷³See e.g., Federal Contracting, ASBCA 28957, 84-2 BCA 17481. Here the contractor was entitled to recover a portion of its unabsorbed overhead claim under the Differing Site Conditions clause and a portion under the Suspension of Work clause--recovery was computed using the *Eichleay* formula. Under the Suspension of Work clause, the contractor was entitled to an adjustment for the unreasonable period of delay only (7 days of delay were considered reasonable) and was not entitled to any profit on the amount recovered. In contrast, the contractor was entitled to an adjustment for the entire period of delay attributable to the differing site condition and profit as well.

²⁷⁴Cases permitting recovery of unabsorbed overhead under the Changes or Differing Site Conditions clause include *Savoy Construction v. United States*, unpublished opinion, Appeal No. 83-1029 (C.A.F.C., Feb 7, 1984); *Fortec Constructors v. United States*, 8 Cl. Ct. 490 (1985); *Cieszko Construction*, ASBCA 34199, 88-1 BCA 20223 at 102,419; *Roberts Construction*, ASBCA 34062, 87-3 BCA 20117; *Excavation-Construction*, ENG BCA 3837, 86-1 BCA 18638; *E. Patti & Sons, Inc.*, PSBCA 1024, 85-2 BCA 18144; *Savoy Construction* ASBCA 21218, 85-2 BCA 18073; *George E. Jenson Contractor*, ASBCA 29772, 85-1 BCA 17833; *Excavation-Construction*, ENG BCA 3851, 84-3 BCA 17646; *Federal Contracting*, ASBCA 28957, 84-2 BCA 17482; *Therm-Air Manufacturing*, ASBCA 16543, 73-1 BCA 9983. For cases permitting recovery of unabsorbed overhead

under the Termination for Convenience clause see *infra* notes 423 and 544.

²⁷⁵See *R. G. Beer, Inc.*, ENG BCA 4885, 86-3 BCA 19012, where at 96,025-26, the Board stated:

In most instances involving changed work the percentage markup on direct costs is used and no further or alternative extended overhead award is considered necessary or appropriate, even where there is an extension of the completion date. . . . Only in unusual circumstances is compensation for unabsorbed/extended overhead recoverable for new work added pursuant to the 'Changes' clause.

See also *Daly Constr.*, ASBCA 32427, 87-3 BCA 20182 at 102,150-51; *Excavation-Constr.*, ENG BCA 3851, 84-3 BCA 17646 at 87,930; *R. W. Contracting*, ASBCA 24627, 84-2 BCA 17302 at 86,220; *L&H Constr.*, ASBCA 23620, 81-1 BCA 14828 at 73,161.

²⁷⁶See *Excavation-Constr.*, ENG BCA 3851, 84-3 BCA 17646 at 87,930; *George E. Jenson Contractor, Inc.*, ASBCA 29772, 85-1 BCA 17833 at 89,252. Award of unabsorbed overhead is not automatic. See *Bromley Contracting v. United States*, 14 Cl. Ct. 69, 81 (1987) (denying unabsorbed overhead on a 148-day increase in the work performance period because contractor failed to prove that costs incurred during that period exceeded the markups for overhead and profit already awarded).

²⁷⁷See *R. G. Beer, Inc.*, ENG BCA 4885, 86-3 BCA 19012 at 96,026.

²⁷⁸*Eichleay Corp.*, ASBCA 5183, 60-2 BCA 2688 at 13,568, *aff'd on motion for reconsid.*, 61-1 BCA 2894.

²⁷⁹*Schindler Haughton Elevator Corp.*, GSBGA 5390, 80-2 BCA 14671, at 72,352.

²⁸⁰*Allegheny Sportswear Co.* ASBCA 4163, 58-1 BCA 1684 at 6364. This method and variations of it also are known as the burden fluctuation method.

²⁸¹*A.C.E.S., INC.*, ASBCA 21417, 79-1 BCA 13809 at 67,722.

282Cateret Work Uniforms, ASBCA 1647, 6 CCF 61561 (1954), at 52,254.

283Allied Materials and Equip. Co., ASBCA 17318, 75-1 BCA 11150 at 53,089-90. This is considered a variation of the Allegheny method. See Capital Electric, GSBGA 5316, 83-2 BCA 16548 at 82,313, *rev'd on other grounds*, 729 F.2d 743 (C.A.F.C. 1984).

284See Bedingfield and Wright, *supra* note 27, at 14-30 to 14-36.

285See Capital Elec. v. United States, 729 F.2d 743, 744 (C.A.F.C. 1984).

286See e.g., Berley Indus. v. City of New York, 412 NYS2d 589, 592 (1978). "[T]he mathematical computations under the 'Eichleay formula' produce a figure with at best a chance relationship to actual damages, and at worst no relationship at all." (characterizing the daily overhead rate calculated under *Eichleay* as a "harsh daily penalty"). Accord Kansas City Bridge Co. v. Kansas City Structural Steel Co., 317 S.W.2d 370, (1958); General Ins. Co. v. Hercules Constr., 385 F.2d 13 (8th Cir. 1967); W. G. Cornell Co. v. Ceramic Coating Co., 626 F.2d 990 (5th Cir. 1980); Guy James Constr. v. Trinity Indus., 644 F.2d 525 (5th Cir. 1981).

287Capital Elec., GSBGA 5316, 83-2 BCA 16548 at 82,315, *rev'd on other grounds*, 729 F.2d 743 (C.A.F.C. 1984).

288*Id.* at 82,313-14.

289Capital Elec. v. United States, 729 F.2d 743 (C.A.F.C. 1984).

290*Id.* at 745-46.

291Fred R. Comb Co. v. United States, 103 Ct.Cl. 174 (1945).

292Capital Elec. v. United States, 729 F.2d 743, 746 (C.A.F.C. 1984).

293*Id.* at 746-47.

294 *Savoy Constr.*, ASBCA 21218, 80-1 BCA 14392, *motion for reconsid. denied*, 80-2 BCA 14724, *aff'd*, 2 Cl.Ct. 338 (1983), *rev'd*, unpublished opinion, Appeal No. 83-1029 (C.A.F.C. 1984).

295 *Id.* at 70,970.

296 *Id.* at 341-42.

297 *Excavation-Constr.*, ENG BCA 3851, 84-3 BCA 17646.

298 *Id.* at 8730.

299 See e.g., Irwin, *The Return of Eichleay: Is It Here to Stay?* *Constr. Claims Monthly*, Vol. 6, No. 6 (June 1984) (stating that the Court failed to address the very real criticisms of the *Eichleay* formula and suggesting that the *Eichleay* formula will not be around long); McGovern, *Compensating Contractors for Delay-Related Costs*, "Eichleay" *After Capital Electric*, *Cont. Mgmt. J.*, 14 (Oct. 1984); Melton, *Common Sense About Home Office Overhead--Part I & II*, *Constr. Claims Monthly*, Vol. 7, Nos. 5 and 6 (May & June 1985).

300 *Bromley Contractors v. United States*, 14 Cl.Ct 69, 81 (1987); *Fortec Constructors v. United States*, 8 Cl.Ct. 490 (1985); *Cieszko Constr.*, ASBCA 34199, 88-1 BCA 20223 at 102,419; *Stephenson Assocs.*, GSBGA 6573, 86-3 BCA 19071; *R.G. Beer Corp.*, ENG BCA 4885, 86-3 BCA 19012; *Ricway, Inc.* ASBCA 30056, 86-3 BCA 19138; *G.S. and L. Mechanical and Constr.*, DOT CAB 1640, 86-3 BCA 19026; *Ricway, Inc.* ASBCA 29983, 86-2 BCA 18841; *Wickham Contracting*, IBCA 1301-8-79, 86-2 BCA 18887; *Excavation-Constr.*, ENG BCA 3837, 86-1 BCA 18638; *Don Cherry, Inc.*, ASBCA 27795, 85-2 BCA 18150; *Able Contracting*, ASBCA 27411, 85-2 BCA 27411; *E. Patti & Sons, Inc.*, PSBCA 1024, 85-2 BCA 18144; *Savoy Constr.*, ASBCA 21218, 85-2 BCA 18073; *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016; *Shirley Contracting*, ASBCA 29848, 85-1 BCA 17858, *aff'd on reconsid.*, ASBCA 29848, 85-2 BCA 18019; *George Hyman Constr.*, ENG BCA 4541, 85-1 BCA 17847, *aff'd*, 621 F. Supp. 898 (D.C.D. 1985); *George E. Jenson Contractor*, ASBCA 29772, 85-1 BCA 17833; *Excavation-Constr.*, ENG BCA 3851, 84-3 BCA 17646; *Federal Contracting*, ASBCA 28957, 84-2 BCA 17482; *Vepco, Inc.*, ASBCA 26993, 84-2 BCA 17255; *R. W. Contracting*, ASBCA 24627, 84-2 BCA 17302.

301G.S. and L. Mechanical and Constr., DOT CAB 1640, 86-3 BCA 19026 at 96,099. The Board then permitted the contractor to recover under the *Eichleay* formula commenting, "It may well be that the *Eichleay* formula is inaccurate, and a gross distortion, too related to time to the exclusion of other factors, and too premised upon the false presumptions that we have noted above. However, respondent has not given us any more realistic method of performing a computation of home office overhead for the suspension period."

302Don Cherry, Inc., ASBCA 27795, 85-2 BCA 18150 at 91,118.

303Ricway, Inc. ASBCA 29983, 86-2 BCA 18841 at 94,955.

304See *supra* note 97 and accompanying text. See also Charles W. Schroyer, Inc., ASBCA 21859, 78-1 BCA 21859. Here, the Government correctly argued that the contractor's failure to include in billings two contracts (on which it worked during the 67-days of delay but did not bill during the contract performance period) distorted the *Eichleay* computation. Incredibly, the Board disagreed.

305Unabsorbed overhead is most often thought of in connection with home office costs. CAS 403 requires that home office expenses be distributed on the basis of the beneficial or causal relationship existing between the home office costs and the receiving activities or on a basis reflecting the total activity of the business as a whole. See 4 CFR 403.40(a)(1) and (c). Thus, under CAS 403, billings would not be an acceptable distribution base for home office expense.

306The CAS recognize home office expenses are not always fixed and that a causal relationship may exist. CAS 403 states "[h]ome office expenses shall be allocated on the basis of the beneficial or causal relationship between the supporting and receiving activities." 4 CFR 403.40(a)(1) (emphasis added).

307Note, *Home Office Overhead as Damage for Construction Delays*, 17 Ga. L. Rev. 761, 794 (1983). See Salt City Contrs., VABCA 1362, 80-2 BCA 14713 at 72,559, "The equitable result sought by utilization of the *Eichleay* formula may be distorted by including in the computations home office expenses which vary substantially with the degree of performance of work." See also R. NASH, GOVERNMENT CONTRACT

CHANGES, 394 (1st ed. 1975), 648 (1981 Supplement); R.G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012 at 96,029-30; Kemmons-Wilson, Inc., ASBCA 16167, 72-2 BCA 9689 at 45,254-55.

308 "In the construction contract environment there is a presumption, rebuttable by the Government, that home office costs are fixed and no reduction to eliminate variable costs is necessary." R.G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012 at 96,030. See also Salt City Contractors, VACAB 1366, 80-2 BCA 14713 at 72,559; Braude and Kovars, *supra* note 260, at 7; Nash, *supra* note 307, at 648.

309 In addition to other contract work, idle crew members may perform routine cleaning of tools and other housekeeping functions, obtain needed training, or take accrued vacation time--all necessary for the contractor's continued existence as a business entity.

310 See R.G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012 at 96,027.

311 Several recent board cases have incorrectly stated that the *Eichleay* formula has a built in corrective mechanism to reflect the extent of other work performed. See George Hyman Constr., ENG BCA 4541, 85-1 BCA 17847 at 89,354; R.G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012 at 96,028:

[T]he *Eichleay* formula has a built-in corrective mechanism to reflect the extent of other projects performed during the delay period. To the degree other work is performed and billed, the billings ratio denominator is decreased, automatically shifting overhead costs from the delayed contract to such other work proportionate to the amount billed.

The proposition that overhead costs are "automatically" shifted from the delayed contract in proportion to the amount of other work billed is incorrect. Under the *Eichleay* formula the mitigatory effect of substituted work is shared proportionately by all of the contractor's contracts. Only the delayed contract which enabled the substituted work to be performed should be credited with the mitigatory effect of the substituted work.

312 See T. Edem, *Claims for Unabsorbed Overhead on Defense Contracts*, unpublished thesis on file at Air Force Institute

of Technology Library, Wright-Patterson AFB, Ohio, at 120 (Sept. 1985). See also McDonald, *Recovery of Home Office Overhead--A Different Point of View*, Constr. Claims Monthly, Vol. 5, No. 12 (Dec. 1983).

313 See Edem, *supra* note 312, at 120.

314 See *Able Contracting*, ASBCA 27411, 85-2 BCA 18017 at 90,385, where the contractor recovered only half its unabsorbed overhead as calculated under the *Eichleay* formula because the Board found it was capable of doing two jobs at the same time. "The Government-responsible delay was not responsible for [the contractor's] failure to obtain other work." *Id.*

315 With respect to unabsorbed overhead, the presumption is that the contractor's distribution base is decreased by the same amount regardless of when during contract performance the delay occurs or at what time during the year that the delay occurs. With respect to extended overhead, the presumption is that a contract receives benefits from home office costs at a constant rate throughout the contract performance period.

316 This criticism of the *Eichleay* formula was acknowledged 21 years ago in *Fullerton Construction*, ASBCA 11500, 67-2 BCA 6394 at 29619. The ASBCA held that the *Eichleay* formula "is not always an appropriate formula" and refused to apply it to a delay occurring after substantial completion of the contract. See also *Seckinger & Co.*, ASBCA 26233, 82-1 BCA 15793.

317 See e.g., *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016. Here the contractor claimed its "overhead largely was 'incurred' at the beginning of the project rather than evenly throughout the project because most of the overhead is expended in setting the job in motion including negotiating with subcontractors, determining delivery dates, submittals, scheduling the project, reviewing the plans and specifications, meetings with the superintendent, site visits, preconstruction conferences, etc." *Id.* at 90,365. Likewise, the end of a construction project often requires considerable home office attention; final inspection must be scheduled, punch list items must be monitored, and clean up efforts must be made. See *Capital Electric--Eichleay's Swan*

Song? R. Walters, 19 Pub. Cont. Newsl. 3, at 4 (Winter 1984).

318 See G.S. and L. Mechanical and Constr., DOT CAB 1640, 86-3 BCA 19026.

This presumption is false because most assuredly there is less home office activity with regards to a contract that is inactive under a suspension, than with regard to one which is proceeding at full steam, with payrolls to be prepared, supply orders to be processed, and subcontracts to be administered.

Id. at 96,097-98.

319 See *supra* notes 100-05 and accompanying text.

320 See *supra* note 99 and accompanying text.

321 *Id.*

322 For a discussion of how costs respond to change see *supra* notes 108-118.

323 See e.g., *Allied Materials and Equip.*, ASBCA 17318, 75-1 BCA 11150 at 53,089, where recovery of unabsorbed overhead using the *Eichleay* formula would have allowed a recovery of \$145,915 more than the contractor's actual unallocated residual manufacturing overhead and G&A expense.

324 Note, *Home Office Overhead as Damage for Construction Delays*, Ga. L. Rev., 799-809 (1983).

325 *Id.*, at 800. See also *Therm-Air Mfg.*, ASBCA 16453, 73-1 BCA 9983 at 46,865.

326 Note, *Home Office Overhead as Damage for Construction Delays*, Ga. L. Rev., 804 (1983).

327 *Capital Elec. v. United States*, 729 F. 2d 743, 747 (C.A.F.C. 1984).

328 The Federal Circuit summarily denied Capital Electric recovery under the modified version of the *Eichleay* formula stating that the record did not support its use. *Id.* See

also R. G. Beer Corp., ENG BCA 4885, 86-3 BCA 19012 at 96,026; G.S. and L. Mechanical and Constr., DOT CAB 1640, 86-3 BCA 19026 at 96,098; Dawson Constr., GSBKA 4956, 79-2 BCA 13989 at 68,635. But see Schindler Haughton Elevator Corp., GSBKA 5390, 80-1 BCA 14681 at 72,352, where the Board on its own initiative applied an unusual variation of the modified *Eichleay* formula.

329 Projected indirect cost rates and changes deleting work are discussed *supra* Chapter 2, Parts I.A and I.D.2, respectively.

330 Estimates form an acceptable starting point for computing an equitable adjustment "if they are supported by detailed substantiating data or are reasonably based on verifiable experience." *Celesco Indus.*, ASBKA 21928, 81-2 BCA 15260, at 75,547-48. Cf. *Targarelli Bros. Constr.*, ASBKA 34793, 88-1 BCA 20363 at 102,989.

331 See *supra* Chapter 3, Part II.B.3.

332 Because the contractor has not incurred additional costs, increased cost is not the basis of its entitlement. The Government has obtained a benefit, something of value, from the contractor and it is that value that is being measured.

333 The reasonable cost of providing the additional home office services can be determined in the following manner. Multiply the number of hours worked by each home office employee to provide the additional services by the employee's hourly wage rate. Then determine a proportionate share of other fixed home office costs based on the ratio of home office labor dollars of the increased administrative effort to total home office labor dollars of the period. The sum of the two computations equals reasonable cost.

334 To compute the adjustment necessary to prevent double recovery:

(1) Determine that portion of the contractor's indirect cost groupings allocable to the contract before the value of the services provided the contract during the period of extension are removed

(2) Determine that portion of the contractor's indirect cost groupings allocable to the contract after the value of

services provided the contract during the period of extension have been removed therefrom.

(3) Subtract the allocable portion of the indirect cost grouping as determined in step 1 from that as determined in step 2 to obtain the adjustment necessary to prevent double recovery.

³³⁵Capital Elec. v. United States, 729 F. 2d 743 (C.A.F.C. 1984).

³³⁶Savoy Constr. v. United States, unpublished opinion, Appeal No. 83-1029 (C.A.F.C. 1984).

³³⁷*The Government Contractor*, No. 84-2, 13 (Feb. 1984), after noting that the Court of Appeals for the Federal Circuit had reversed *Capital Electric* and *Savoy Construction* stated: "This means that the *Eichleay* formula is not dead. However, the circumstances under which it can be applied are not yet perfectly clear."

³³⁸Capital Elec. v. United States, 729 F. 2d 743, 746 (C.A.F.C. 1984).

³³⁹Also note that the Federal Circuit's decision in *Savoy Construction* is an unpublished opinion. See *Savoy Constr. v. United States*, unpublished opinion, Appeal No. 83-1029 (C.A.F.C. 1984). Unpublished opinions have no precedential value.

³⁴⁰Capital Elec. v. United States, 729 F. 2d 743, 746 (C.A.F.C. 1984).

³⁴¹See *supra* Chapter 3, Part II.C.2.d.

³⁴²See *supra* notes 304-22 and accompanying text.

³⁴³G.S. and L. Mechanical and Constr., DOT CAB 1640, 86-3 BCA 19026 at 96,101. Accord *Bromley Contracting*, DOT CAB 1284, 83-2 BCA 17233. In *Bromley Contracting* the DOT CAB commented: "The *Eichleay* formula and formulas similar to it, are used as guides for equitable adjustments (sic) calculations, but must be used with care sufficient to ensure that the results somewhat comport to reality." *Id.* at 85,825.

344Excavation Constr., ENG BCA 3858, 82-1 BCA 15770 at 78,071. See also Miles Const., VABCA 1674, 84-1 BCA 16967 at 84,374 (using jury verdict approach limited recovery to 90% of per diem rate).

345See *G.S. and L. Mechanical and Constr.*, DOT CAB 1640, 86-3 BCA 19026 at 96,099, where the Board commented "[T]he majority opinion in Capital Electric, above, appears to be inviting litigants in an appropriate case to have the Court of Appeals conduct *en banc* review of the Eichleay approach."

346Eichleay Corp., ASBCA 5183, 61-1 BCA 2894, at 15118 (emphasis added). See also Allied Materials and Equip., ASBCA 17318, 72-2 BCA 11150 at 53,089.

347See Braude and Kovars, *supra* note 260, at 7.

348See *Essex Electro Eng'rs*, ASBCA 21066, 79-2 BCA 14035, at 68,952, where the Board decided to use the *Eichleay* formula as a measure of damages rather than the burden fluctuation method recommended by the Government reasoning, "We are persuaded that the appellant has computed its claim in a reasonable manner and on a reasonable basis. This presumption of reasonableness has not been rebutted." See also *G.S. and L. Mechanical and Constr., Inc.*, DOT CAB 1640, 86-3 BCA 19026, at 96,101. "The ultimate test of any formula to compute the amount of home office overhead chargeable to a contract during a suspension period remains that of reasonableness, and it is a contractor's task to convince us that its proposed method of computation is reasonable." *Id.* (emphasis added).

349FAC 84-26 (July 30, 1987) amending FAR 31.201-3.

350This approach was commended to the committees that draft procurement regulations by the Board in *G.S. and L. Mechanical and Construction*, DOT CAB 1640, 86-3 BCA 19026 at 96,100.

351See *supra* notes 200-04 and accompanying text.

352See *Sante Fe Eng'rs v. United States*, 801 F.2d 379 (C.A.F.C. 1986); *West Land Builders*, VABCA 1664, 83-1 BCA 16235.

353 See *Sante Fe Eng'rs v. United States*, 801 F.2d 379 (C.A.F.C. 1986).

354 GSA has used a clause limiting recovery of overhead on construction contracts for over 20 years. Only two Federal agencies have followed GSA's lead--the Postal Service and the VA. Notably, DOD has not adopted a similar clause.

355 A percentage markup for indirect costs can be at either the contractor's normal indirect cost rate or at the standard markup for indirect costs (normally 10% or 15%).

356 See *Luria Bros. & Co. v. United States*, 177 Ct. Cl. 676, 693 (1966); *J. D. Hedin Constr. v. United States*, 171 Ct. Cl. 70, 108 (1965); *R. G. Beer Corp.*, ENG BCA 4885, 86-3 BCA 19012 at 96,031-32; *Excavation-Constr.*, ENG BCA 3837, 86-1 BCA 18638 at 93,669 (crediting the Government with \$40,647 of home office expense already recovered by the contractor as a percentage markup on direct costs incurred during the delay); *Able Contracting*, ASBCA 27411, 85-2 BCA 18017 at 90,386; *Savoy Constr.*, ASBCA 21218, 85-2 BCA 18073 at 90,723; *George Hyman Constr.*, ENG BCA 4541, 85-1 BCA 17847 at 89,355, *aff'd*, 621 F. Supp. 898 (D.D.C. 1985); *Excavation-Constr.*, ENG BCA 3851, 84-3 BCA 17646 at 87,930; *R.W. Contracting*, ASBCA 24627, 84-2 BCA 17302 at 86,223; *Sovereign Constr.*, ASBCA 17792, 75-1 BCA 11,251 at 53,611; *Eichleay Corp.*, ASBCA 5183, 60-2 BCA 2688, *aff'd on reconsid.*, 61-1 BCA 2894 at 13,576 (a percentage markup on increased direct costs resulting from the delay was denied as duplicative of unabsorbed overhead). See also *Stephenson Assoc.*, 86-3 BCA 19071 at 96,354 (to compensate for duplication in overhead between change orders already priced out by mutual agreement of the parties and *Eichleay* unabsorbed overhead allowed by the Board, profit on the unabsorbed overhead was disallowed). But see *Shirley Contracting*, ASBCA 29848, 85-1 BCA 17858, *aff'd on reconsid.*, ASBCA 29848, 85-2 BCA 18019 at 89,404 (allowing both *Eichleay* unabsorbed overhead and a 15% markup on work performed during the delay--the Government did not know what the 15% overhead markup was for); *Charles W. Schroyer, Inc.*, ASBCA 21859, 78-1 BCA 21859 at 66,226 (duplication was *de minimis*); *Canon Constr.*, ASBCA 16142, 72-1 BCA 9404 (based on testimony that it was not duplicative, a 10% markup on direct costs was not deducted from recovery of extended overhead).

357The formula used in *Cateret Work Uniforms*, ASBCA 1647, CCF 61,561 (1954) is one example. Here unabsorbed overhead is computed by multiplying the excess rate of overhead by total base costs during the period of delay. Any additional work performed by the Contractor during the delay will reduce the excess rate of overhead.

358See *supra* notes 309-13 and accompanying text.

359In some instances, home office expense will consist of almost all fixed indirect cost. This is particularly true in the construction industry. See *supra* note 308 and accompanying text. On the other hand, manufacturing overhead is likely to include a significant percentage of variable indirect costs.

360Unabsorbed overhead includes no variable indirect costs. Variable indirect costs are removed from the indirect cost pools before computation of unabsorbed overhead. See *supra* note 307 and accompanying text.

361See *A.C.E.S., Inc.*, ASBCA 21417, 79-1 BCA 67,711. The contractor unsuccessfully sought recovery of both unabsorbed overhead and storage costs of Government items being repaired. The Board denied such recovery, finding storage to be a fixed indirect cost already recovered in the allowance for unabsorbed overhead. See also *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,377 (disallowing as a direct cost the time spent by contractor's executives in handling problems in that such cost was already recovered in the allowance for unabsorbed overhead).

362See *infra* Chapter 4, Parts. II.D, V, and VI.B.2.

Note 363 begins on page 230.

363 FAR 49.201(a). Stated somewhat differently, "the purpose of a settlement agreement is to make the contractor 'financially whole for all the direct consequences' of the termination, anticipated profits aside." Tera Advanced Servs., GSBICA 6713-NRC, 85-2 BCA 17940 at 89,882 (citations omitted).

364 FAR 52.249-2(f)(3).

365 FAR 49.201(b).

366 FAR 49.109-7(a).

367 FAR 49.109-7(d).

368 FAR 49.201(a). "In a given case, various methods may be equally appropriate for arriving at fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement." *Id.*

369 See Celesco Indus., ASBCA 22460, 84-2 BCA 17264 at 86,162.

370 See e.g., Agrinautics, ASBCA 21512, 79-2 BCA 14149 at 69,647-48; Allied Materials and Equip., ASBCA 17318, 75-1 BCA 11150 at 53,085; Bell and Howell Co., ASBCA 18464, 75-1 BCA 10993 at 52,348; Crescent Precision Prods., ASBCA 18705, 74-2 BCA 10898 at 51,870; Algonac Mfg., ASBCA 10534, 66-2 BCA 26,718 at 26,726.

371 See e.g., Worsham Constr., ASBCA 25907, 85-2 BCA 18016 at 90,378 (actual audited rate); Hewitt Contracting, ENG BCA 4596, 83-2 BCA 16816 at 83,640-41 (audited rate); Paul E. McCollum, Sr., ASBCA 23269, 81-2 BCA 15311 at 15,311-12; Globe Air, Inc., AGBCA 76-119, 78-1 BCA 13079 at 63,877; Henry Spen & Co., ASBCA 20766, 77-2 BCA 12784 at 62,172 (audited rate); Varo, Inc., ASBCA 16606, 72-2 BCA 9720 at 45,395-96; Manuel M. Lioudas, ASBCA 12829, 71-2 BCA 9015 at 41,879; Nolan Bros., ENG BCA 2680, 67-1 BCA 6095 at 28,219. But see Rossen Builders, ASBCA 32305, 87-1 BCA 19538 at 98,727-28 (prior year's G&A rate was used by Government and accepted by Board in lieu of unsupported rate claimed by contractor).

372 Termination settlements because of their complexity and because not all costs are known at the time of contract termination, take time to prepare and negotiate. The contractor's accounting period normally ends well before a

settlement agreement is reached. The cost of safeguarding and disposing of the terminated inventory is an example of a cost not known at the time of termination.

373 See generally *supra* notes 98-106 and accompanying text.

374 Surprisingly, the choice of base period is infrequently litigated or discussed in Board cases. Chapter 5 argues that use of the period of contract performance as the base period rather than the contractor's normal base period is an inconsistent accounting practice. See *infra* notes 705-09 and accompanying text.

375 See *Penberthy Electromelt Int'l v. United States*, 11 Cl.Ct. 307, 319 (1986). In *Penberthy* the Court denied contractor's use of a four year average G&A base period holding that the base period "must be a period during which contract costs are incurred." *Id.* See also *R-D Mounts, Inc.*, ASBCA 17422, 75-1 BCA 11077 at 52,741-42 (allowing the six month base period proposed by the Government because it was longer, more representative, and included a portion of the performance period whereas the base period proposed by the contractor did not). See also *Francis Assoc.*, ASBCA 14100, 70-2 BCA 8493 at 39,474-76. The contractor unsuccessfully argued that year ending prior to the period of contract performance should be the base period used for the termination because it constituted a fair representation of normal operations as evidenced by previous acceptance on this contract and others by the Government. The Government had audited the indirect cost rates of the prior period and had approved their use for progress payment purposes for the terminated contract. Nonetheless, the Board adopted the 18 month period of contract performance as the base period. Use of the year ending prior to the period of contract performance as the base period would have resulted in a manufacturing overhead rate of 105.95% and an engineering overhead rate of 98.65%; use of the period of performance resulted in a combined rate of 31.15%.

376 Indirect costs allocable to a contract are normally determined by multiplying the contractor's indirect cost rate times the direct costs generated by the contract. When the contract proceeds to completion, this accounting practice usually will permit full recovery of indirect costs.

377 See *Alston*, *supra* note 148, at 389; *Bedingfield and Rosen*, *supra* note 27, at 15-11 through 15-13; A. JOSEPH & N. O'DONNELL, *TERMINATION OF GOVERNMENT CONTRACTS*, XII-20 (Fed. Pub.

1987); W. Petit and L. Victorino, *Post-Termination Costs II*, Gov't Contractor, Briefing Papers, No. 84-6, at 4 (June 1983); Rishe, *supra* note 27, at 15-11. Trueger, *supra* note 27, at 772-73, comments:

For example, if most of the material has been purchased and received, and very little direct labor applied, and if purchasing and receiving expenses are in the manufacturing overhead pool, it is obvious that an allocation of factory overhead as a percentage of direct labor will not produce an equitable apportionment of such costs to the terminated contract. The circumstances of early termination described above is quite common. When it is encountered, appropriate and equitable costing demands a departure from the contractor's usual accounting procedures.

378 See Worsham Constr., ASBCA 25907, 85-2 BCA 18016:

[I]t is important to recognize that allocation bases normally are necessary, but artificial, surrogates designed to approximate the benefits received by a contract (or other cost objective) from the incurrence of indirect costs. To the extent that a base fails to fulfill its function of measuring equitable, causal and/or beneficial relationships reasonably accurately it should be discarded unless its use otherwise is required, for example by contract, law or regulation.

Id. at 90,375

379 FAR 31.205-42(c). See Bedingfield and Rosen, *supra* note 27, at 15-12 and 15-20.

380 See FAR 31.205-42(c)(1).

381 *Id.*

382 See FAR 31.205-42(c)(2).

383 *Id.*

384 See e.g. Dunbar Kapple, Inc., ASBCA 3631, 57-2 BCA 1448 at 4890. Cf. *infra* notes 476-77.

385 See e.g., Tera Advanced Servs., GSBICA 6713-NRC, 85-2 BCA 17940 at 89,888 (allowing as a direct cost freight, equipment rental, postage, telephone, data processing); Agrinautics, ASBCA 21512, 79-2 BCA 14149 at 69,648 and 69,650 (allowing reclassification of president's time from engineering overhead and G&A to direct engineering labor cost); Okaw Indus., ASBCA 17863, 77-2 BCA 12793 at 62,229-31 (allowing reclassification as a direct cost: supervisory time, freight charges, equipment repairs, small tools, travel, telephone, and other office expenses); R-D Mounts, Inc., ASBCA 17422, 75-1 BCA 11077 at 52,738 (allowing as a direct cost the cost of revising contractor's accounting system to better substantiate progress payment requests); Allied Materials and Equip. ASBCA 17318, 75-1 BCA 11150 at 53,806 (allowing as a direct cost legal fees of negotiating equitable adjustments during contract performance); Douglas Corp., ASBCA 8566, 69-1 BCA 7578 at 35,145-56 (allowing as a direct cost a percentage of officers' salaries and office rent, telephone expense, legal and accounting fees, travel, and insurance). See also General Elec., ASBCA 24111, 82-1 BCA 15725, *motion for reconsid. denied*, 82-2 BCA 16207.

It is axiomatic that certain costs normally treated as overhead expenses may, upon termination of the contract with which those costs are associated, properly be allocated directly to the termination contract and be recoverable in a termination settlement. . . . Such direct allocation of otherwise indirect costs is singularly appropriate in situations where, as here, no end items have been produced or delivered and no direct labor costs, against which overhead rates may be applied, have been incurred.

Id. at 77,801(citations omitted).

386 Switlik Parachute Co., ASBCA 18024, 75-1 BCA 11434, at 54,443.

387 See e.g., Rossen Builders, ASBCA 32305, 87-1 BCA 19538 at 98,727 (holding bid estimator's time and delivery costs were already in G&A--allowance as direct costs would permit double recovery); Fiesta Leasing and Sales, ASBCA 29311, 87-1 BCA 19622 at 99,292 (disallowing marketing expenses associated with obtaining the contract--no indication officer's salary was removed from G&A and evidence was too speculative as to the amount of the proposed direct charge); Arctic Corner, Inc, VABCA 2393, 86-3 BCA 19278 at 97,457 (holding that bid preparation costs are normally a part of overhead; also

finding a lack of credible evidence as to what it cost to bid the contract); Worsham Constr., ASBCA 25907, 85-2 BCA 18016 at 90,377 (salary of owners allowed only as an indirect cost-Board had allowed unabsorbed overhead and considered direct recovery duplicative); Tera Advanced Servs., GSBGA 6713-NRC, 85-2 BCA 17940 at 89,888 (outside services and subscriptions/publications were so inherently overhead in nature that they were disallowed as direct costs in the absence of a specific explanation as to why they were charged directly); Robert M. Tobin, HUD BCA 79-388-C20, 84-3 BCA 17,651 at 87,971 (disallowing work force recruitment as a direct cost); Starks Contracting, VACAB 1339, 79-2 BCA 1448 at 68,847-48 (contractor's accounting system was inadequate to allow reclassification of indirect costs--identification of costs with contract was based on contractor's estimates which the Board found speculative); Systems & Computers Information, Inc., ASBCA 18458, 78-1 BCA 129456 at 63,137 (costs of persuading the contracting officer not to default terminate contractor and of the merits of changes claimed by contractor were already included as indirect charges); R-D Mounts, Inc., ASBCA 17422, 75-1 BCA 11077 at 52,733-34 (disallowing freight costs as a direct cost because the amount was unsubstantiated and could not be specifically identified with the terminated contract); Cyro-Sonics, Inc., ASBCA 13219, 70-1 BCA 8313 at 38,640 (disallowing as a direct cost the cost of small tools because they were used on other jobs after termination).

388 *Id.* Cf. *infra* notes 476-77.

389 Both the Cost Principles and CAS require contractors to be consistent in their classification of costs as direct or indirect. See FAR 31.202(a) and FAR 30.402. The question of whether direct charging of indirect pre-termination costs is an inconsistent accounting practice is particularly important when direct recovery is not specifically authorized by the FAR.

390 Consistency, as it applies to the recovery of indirect costs is also discussed in Chapter 5 of this thesis. Chapter 5 discusses classification of costs as direct or indirect in greater depth but the discussion is not specific to terminations for convenience. Nonetheless a careful reading of Chapter 5, Part I.B and II.A will be helpful in understanding the importance of consistently classifying costs as either direct or indirect. Chapter 5's discussion of consistency is not limited to classification of costs as

direct or indirect but discusses consistency in other contexts as well.

³⁹¹FAR 31.202(a); FAR 30.402-40.

³⁹²See FAR 31.205-42(c).

³⁹³The ASBCA in *Kollmorgen Corp., Electro-Optical Division*, ASBCA 18,919, 86-2 BCA 18919 at 95,409-10, declined to decide the issue of whether CAS 402 precluded direct charging of time spent on termination settlement activities by in-house accounting, legal, clerical, and supervisory personnel (G&A expense pool type costs). The reason for the Board's refusal was the small dollar amount (\$3,879) at stake. *Kollmorgen* involved post-termination costs rather than pre-termination costs, but the issue is similar.

³⁹⁴See *supra* note 377.

³⁹⁵See e.g., Alston, *supra* note 148, at 390; Joseph & O'Donnell, *supra* note 377, at X-14; Petit and Victorino, *supra* note 377, at 4. These commentators contend that CAS 402 and FAR 31.202(a) look beyond the circumstances of a cost's incurrence in determining whether "like circumstances" exist and consistency is required. They so not interpret the consistency requirement of CAS 402 and FAR 31.202(a) as restrictively as do Bedingfield and Rosen.

³⁹⁶See Bedingfield and Rosen, *supra* note 27, at 15-13 through 15-15. Bedingfield and Rosen view the one-time allocation as a voluntary accounting change rather than a noncompliance with CAS 401 and 402. The CAS permit a one-time allocation under the special allocation provision of CAS 410. See FAR 30.410-50(j).

³⁹⁷See *infra* note 639 and accompanying text.

³⁹⁸Selective charging of costs as direct or indirect for purposes unrelated to the termination for convenience results in overcharging. See *infra* note 597 and accompanying text.

³⁹⁹CAS 402 has not been interpreted to prevent change in accounting practice if otherwise appropriate; similarly, FAR 31.202(a) does not prevent change in accounting practice if otherwise appropriate. See *infra* Chapter 5, Part III.

400 FAR 31.205-42(c) does not specifically allow all initial costs to be charged directly--only those starting load costs "not fully absorbed because of termination." FAR 31.205-42(c)(1) (emphasis added). The language "not fully absorbed because of termination" evidences an intent to limit direct charging to instances where the contractor's normal method of recovering such costs is inequitable.

401 See FAR 52.230-3 and 52.230-5. See *infra* notes 663-65. for a discussion of the permissibility of retroactive change in accounting practice for CAS-covered and modified CAS-covered contracts.

402 As explained in Chapter 4, Part I.A, *supra*, the overriding objective of a termination settlement is to compensate a contractor fairly for its costs of performing and preparing to perform the terminated contract. Fair compensation rather than strict accounting principles form the heart of a termination settlement. See FAR 49.201(a). When necessary to allow fair compensation boards and courts have allowed costs that would not be allowable under the cost principles. See *infra* notes 444-53 and accompanying text. This principle should apply by analogy to each of these two clauses. Further, it is difficult to argue that either of the two clauses were intended to exclude direct charging of pre-termination costs that FAR 31.205-42(c) specifically allows. Finally, the clauses seldom have been used as a basis for prohibiting retroactive change even when apparently applicable. See *infra* note 663.

403 The need to remove the direct charge from the indirect cost pool is obvious to all commentators and to courts and boards. See e.g., Joseph & O'Donnell, *supra* note 377, at X-13. "Clearly the cost reallocated from indirect to direct must be removed from the overhead pool." See also Robert M. Tobin, HUD BCA 79-388-C20, 84-3 BCA 17651 at 87,971; Agrinautics, ASBCA 21512, 79-2 BCA 14149 at 69648; Okaw Indus., ASBCA 17863, 77-2 BCA 12793 at 62,235; Allied Materials & Equip., ASBCA 17318, 75-1 BCA 11150 at 53,087; Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,890. Cf. Tera Advanced Servs., GSBCE 6713-NRC, 85-2 BCA 17940 at 89,890. "[I]f we were shown that some of the costs in appellant's G&A pool were also claimed as settlement costs, we would disallow them instantly."

404 FAR 31.203(a). CAS 402 uses slightly different language but the meaning is identical. See FAR 30.402-40.

⁴⁰⁵See e.g., Alston, *supra* note 148, at 390; Joseph & O'Donnell, *supra* note 377, at X-14; Petit and Victorino, *supra* note 377, at 4. But see Bedingfield and Rosen, *supra* note 27, at 15-21. As discussed at *supra* Chapter 4, Part II.B.3.a, a termination for convenience changes neither the purpose for which a cost was incurred nor the circumstances of its incurrence--it changes only the circumstances of its recovery.

⁴⁰⁶Note that if this were to happen, the terminated contract would not be "double" charged, although the term "double counting" is commonly used to describe this effect. The amount of cost allocated to the terminated contract, directly and indirectly, would be less than twice its properly allocable share. First, the amount charged directly is subtracted from the indirect cost pool before its distribution. Second, and more importantly, the amount of direct cost generated by the terminated contract is probably small enough that the terminated contract will not pick up a significant amount of an indirect cost grouping containing other costs incurred for the same purpose. The reason direct charging is permitted is that the direct costs of the terminated contract are such that the contractor's normal indirect cost rates as applied thereto do not fairly compensate the contractor. Therefore, although the terminated contract will be overburdened if costs incurred for the same purpose are not removed from the indirect cost pool, the Government will not pay twice the amount properly chargeable.

⁴⁰⁷See e.g., Tera Advanced Servs., GSBICA 6713-NRC, 85-2 BCA 17940 at 89,890; General Elec., ASBCA 24111, 82-1 BCA 15725 at 77,802, *motion for reconsid. denied*, 82-2 BCA 16,207; Bailfield Indus., Div. of A-T-O, ASBCA 20006, 76-2 BCA 12096 at 58,114-15.

⁴⁰⁸Settlement costs are not incurred in performance of the contract but are costs directly resulting from termination--costs specifically required by the Termination for Convenience clause. The CASB has interpreted differing circumstances to exist under CAS 402 when a cost is incurred pursuant to a specific requirement of an exiting contract. The CASB Interpretation involved bid and proposal costs required by specific contract provisions--an analogous situation. See FAR 30.402-61:

Under 30.402, costs incurred in preparing, submitting, and supporting proposals pursuant to a specific

requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirement. The circumstances are different because the costs of preparing proposals specifically required by the provision of an existing contract relate only to that contract while other proposal costs relate to all the all the work of the contractor.

409 Removal of attorney fees, unrelated to the termination settlement and otherwise properly includable in the indirect cost base, is not necessary to prevent double recovery and would result in the terminated contract not bearing a fair share of such costs. The pre-termination work benefited from the incurrence of attorneys' fees in the same general way as did other cost objectives and for this reason should bear a proportionate share of such costs. See e.g., Hewitt Contracting, ENG BCA 4596, 83-2 BCA 16816 at 83,645.

410 See *supra* notes 90-94 and accompanying text.

411 *Id.* Instead, machine hours, square footage, number of employees, or some other factor which more closely approximates the relative benefits received by the several cost objectives than direct cost is used.

412 See e.g., Sunstrand Turbo, ASBCA 9112, 65-1 BCA 4653 at 22,227; Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,895. Compare Agrinautics, ASBCA 21512, 79-2 BCA 14149 at 69647-48 (allowing engineering overhead and G&A on president's salary reclassified as a direct engineering labor cost--the Board did not discuss why it allowed the markup for engineering overhead or G&A--it may have believed that the President was performing direct cost functions). While manufacturing overhead on a cost normally classified as manufacturing overhead or G&A on a cost normally classified as G&A cannot be recovered, G&A can be recovered on a cost normally classified as manufacturing overhead which for purposes of the termination has been reclassified as a direct cost. See e.g., Allied Materials & Equip., ASBCA 17318, 75-1 BCA 11150 at 53,087-88.

413 *Id.* In *Sunstrand Turbo*, ASBCA 9112, 65-1 BCA 4653 at 22,227, the Board held that the contractor could not recover additional G&A allowance on costs of a general and

administrative nature for which it was reimbursed directly reasoning as follows:

To allow additional G&A expense on termination settlement expense would involve the granting of administrative expense on administrative expense. . . . Had [the administrative costs recovered directly] been included in the base, the result would have been to reduce the rates substantially below the rates now claimed by appellant. Obviously appellant is not entitled to a G&A allowance on its post-termination costs at a rate which has been inflated by the exclusion of such costs from the allocation base.

414 FAR 31.205-42(h).

415 See e.g., Metadure Corp., ASBCA 21183, 83-1 BCA 16208 at 80,536; American Elec., ASBCA 16635, 76-2 BCA 12151 at 58,492-93; Thiokol Chem. Corp., ASBCA 17544, 76-1 BCA 11731 at 55,940; Bolinders Co., ASBCA 5740, 60-2 BCA 2746 at 14,017-18.

416 See e.g., Worsham Constr., ASBCA 25907, 85-2 BCA 18016, at 90,376. The contractor had incurred no direct costs because the Government settled directly with the subcontractor. Therefore, the ASBCA applied the contractor's G&A rate to the reasonable value of the terminated subcontract.

417 Sunstrand Turbo v. United States, 182 Ct.Cl. 31, 57-60 (1968).

418 Sunstrand Turbo, ASBCA 9112, 65-1 BCA 4653 at 22,228.

419 *Id.*

If the subcontract costs had been billable costs prior to the terminations, such costs would have been included in the G&A allocation base for such periods and would have resulted in a redistribution of the G&A pool, causing an increase in the G&A allocated to Contract -27 and Contract -73 with a corresponding reduction in the amount of G&A allocable to appellant's other contract, (sic) but no significant change in the amount of G&A recoverable under all the Turbo Division's CPFF contracts.

420 Worsham Constr., ASBCA 25907, 85-2 BCA 18016 at 90,374-76.

421 pre-termination unabsorbed overhead should be distinguished from post-termination unabsorbed overhead which is not allowable. Entitlement to post-termination overhead is discussed *infra* Chapter 4, Part V.

422 See e.g., *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,362. The Board excluded subcontract costs of the terminated contract from "billings" and "total billings" when computing *Eichleay* damages. Subcontract costs were excluded to prevent over recovery of home office costs. The cause of the Board's concern was the contractor's failure to establish the degree to which the subcontract had benefited from home office costs. The Board had already allowed home office costs to be applied to the subcontract but at 50% of the contractor's normal rate. The Board was concerned that inclusion of subcontract costs in the *Eichleay* formula "billings" would result in the contractor's being overcompensated for home office costs with respect to the subcontract. See also *Marlin Assoc.*, GSBGA 5663, 82-1 BCA 15,738 at 77,881 (finding that *Eichleay* formula "total billings" included the Board's award for completed work, termination inventory, labor, subcontractor work, overhead, and profit; and excluded settlement preparation costs).

423 See e.g., *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,362; *Marlin Assoc.*, GSBGA 5663, 82-1 BCA 15,738 at 77,881; *Racquette River Constr.*, ASBCA 26486, 82-1 BCA 15769 at 78,053; *Agrinautics*, ASBCA 21512, 79-2 BCA 14149 at 69,648-49; *A.C.E.S., INC.*, ASBCA 21417, 79-1 BCA 21417 at 67,722; *Allied Materials & Equip.*, ASBCA 17318, 75-1 BCA 11,150 at 53,089-90.

424 See *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,369.

425 *Id.*

426 *Id.*

427 *Penberthy Electromelt Int'l v. United States*, 11 Cl. Ct. 307 (1986).

428 *Id.* at 324.

429 See *Alston*, *supra* note 148, at 392; H. Andrews and R. Peacock, *Terminations: An Outline of the Parties' Rights and*

Remedies, 11 Pub. Cont. L. J. 269, 278 (1980); Cibinic & Nash, *supra* note 1, at 795; Joseph & O'Donnell, *supra* note 377, at X-5; W. KEYES, GOVERNMENT CONTRACTS UNDER THE FEDERAL ACQUISITION REGULATION, 725 (1986); Halifax Eng'g, ASBCA 34779, 88-1 BCA 20,227 at 102,430; Fiesta Leasing and Sales, ASBCA 29311, 87-1 BCA 19622 at 99,292; Worsham Constr., ASBCA 25907, 85-2 BCA 18016 at 90,369; Robert M. Tobin, HUD BCA 79-388-C20, 84-3 BCA 17651 at 87,970; Racquette River Constr., ASBCA 82-1 BCA 15769 at 78,051; Paul E. McCollum, Sr., ASBCA 23,269, 81-2 BCA 15311 at 75,822; Southland Mfg., ASBCA 16830, 75-1 BCA 10994; International Space Corp., ASBCA 13883, 70-2 BCA 8519; Caskel Forge, Inc.; ASBCA 7638, 1962 BCA 3318.

⁴³⁰Determining costs incurred in performance of the terminated contract is a major issue in most fixed priced settlement negotiations. In contrast, when a cost-reimbursement contract is terminated, establishing what performance costs were incurred is seldom a problem. See Andrews and Peacock, *supra* note 429, at 277. The reason is that the Government will not issue a cost reimbursement contract to a contractor whose accounting system is incapable of tracking costs. See FAR 16.301-3(a). See also Rishe, *supra* note 27.

[Negotiating a termination settlement] can be quite a task when the terminated contract is of the fixed-price type, because such contracts do not require the keeping of detailed cost records as do cost-reimbursement contracts. Such records are of vital importance in determining the cost recovery for a convenience termination.

Id. at 6-43. See also Algonac Mfg., ASBCA 10534, 66-2 BCA 5731 at 26,724. "This settlement would have been made much more easily if appellant's books had been kept in conformity with the regulations and forms of the Government concerning termination settlements. They were not, however, and there was not reason nor requirement that they should be." *Id.*

⁴³¹See Trueger, *supra* note 27, at 738. "Terminations cause unique accounting problems. All cost accounting systems rely on assumptions of normality and continuity." See also Alston, *supra* note 148, at 387; Bedingfield and Rosen, *supra* note 27, at 15-11.

⁴³²"Terminations are aberrations." Bedingfield and Rosen, *supra* note 27, at 15-11.

⁴³³Bedingfield and Rosen, *supra* note 27, at 15-13. See also Trueger, *supra* note 27, at 729. Paul Trueger comments: "If most [preparatory] expenses are generally charged to overhead accounts, without segregation by contract, there may be considerable difficulty in finding and supporting their applicability to the satisfaction of the government auditors. Somewhat similar problems obtain with respect to starting-load costs. . . ." *Id.* at 761.

⁴³⁴See Rishe, *supra* note 27, at 6-23; Joseph & O'Donnell, *supra* note 377, at X-12. Maintenance of such a system on the outside possibility that the Government will terminate a contract for convenience is not economically sound. See e.g., Racquette River Constr., ASBCA 82-1 BCA 15769 at 78,050 (books consisted of a cash receipts journal, cash disbursements journal, and a general journal--common among small contractors in Northwest Florida); Metered Laundry Serv., ASBCA 21573, 78-2 BCA 13451 at 64,601 (ledger did not even allocate costs to particular jobs because doing so could not be cost justified); Starks Contracting, VACAB 1339, 79-2 1448 at 68,847-48 (contractor's books not oriented towards a cost system).

⁴³⁵FAR 49.206-1(c).

⁴³⁶See Arctic Corner, Inc. VABCA 2393, 86-3 BCA 19278 at 97,456-57 ("while comprehensive documentation" is not required the contractor "still must meet the burden of proving the costs were incurred and offer some explanation as to just how those costs were treated (direct or indirect) in its normal business operation"). See also Tagarelli Bros. Constr., ASBCA 34793, 88-1 BCA 20363 at 102,989; Humphrey Logging Co., AGBCA 84-359-3, 85-3 BCA 18433 at 92,572; H&H Reforestation, AGBCA 84-311-3, 85-3 BCA 18255 at 91,637; Tera Advanced Servs., GSBGA 6713-NRC, 85-2 BCA 17940 at 89,883-84; Celesco, Indus., ASBCA 22460, 84-2 BCA 17295 at 86,160; R.G. Robbins & Co., ASBCA 27516, 83-1 BCA 27516 at 81,692; Paul E. McCollum, Sr., ASBCA 23,269, 81-2 BCA 15311 at 75,822; Allied Materials and Equip., ASBCA 17318, 75-1 BCA 11150 at 53,085; Dairy Sales Corp., ASBCA 21193, 75-2 BCA 11613 at 55,455, *aff'd*, 219 Ct. Cl. 431 (1979); Clary Corp., ASBCA 19274, 74-2 BCA 19247 at 52,103.

⁴³⁷FAR 49.206-1(c).

⁴³⁸See e.g., R-D Mounts, Inc., ASBCA 17422, 75-1 BCA 11077 at 52,744, *aff'd on motion for reconsid.*, (disallowing 10%

charge for labor and handling of purchased parts because contractor presented no evidence to substantiate the incurrence of these costs in connection with this contract; recognizing that some handling costs must have been incurred, the Board by jury verdict allowed \$250 of the \$1,201 claimed); Herbert R. Button, ASBCA 17281, 73-1 BCA 9780 at 45,689 (holding that burden of proof is not carried by unsupported allegations).

439 FAR 49.206-1. See also Arnold H. Leibowitz, GSBGA CCR-1, 76-2 BCA 11930 at 57,189 (estimate accepted--the contract did not require the keeping of work time records). Note however, that "[w]hile estimates may be used in the absence of accounting records whose unavailability is not the fault of the contractor, the contractor has the burden of proving the basis for and the accuracy of such estimates." Robert M. Tobin, HUD BCA 79-388-C20, 84-3 BCA 17651 at 87,971 (citations omitted).

440 FAR 49.206-2(b)(ii).

441 See e.g., Chesterfield Assoc., DOT CAB 1028, 80-2 BCA 14580 at 71,898 (G&A expense estimated based on the number of letters written to contracting officer-- \$12.50 per page); The Douglas Corp, ASBCA 8566, 69-1 BCA 7578 at 35,144 (allowing factory overhead in the absence of auditable accounting records because the amount claimed was reasonable relative to contract price and the work done).

442 Termination serves as notice to a contractor that any future costs incurred for the terminated contract must be recovered on what is, in effect, a cost basis and that proof of their incurrence will be a prerequisite to recovery. Thus, consistent with the principles of fairness, a contractor often will be held to a higher burden of proof for costs incurred after termination. See *infra* footnote 491.

443 See e.g., Tagarelli Bros. Constr., ASBCA 34793, 88-1 BCA 20363 at 102,989 (allowing only 20 of 120 hours claimed in bid preparation, none of the 140 hours claimed in production planning, no standby supervision, and no unabsorbed overhead for the 88 days of delay--total lack of documentary support); Concord Elec., ASBCA 31012, 85-3 BCA 18484 at 92,843 (allowing neither overhead nor G&A--contractor failed to present evidence of overhead or G&A rates for the pertinent period); Herbert R. Button, ASBCA 17281, 73-1 BCA 9780. See also L.&H. Constr., ASBCA 22193, 79-2 BCA 13950. In the absence of accounting records supporting this sole

proprietor's settlement claim, the Board assumed that the contractor had included overhead cost in the \$27 cost per labor hour apparently used in computing its fixed price bid. Therefore, a termination settlement based upon this \$27 per hour figure adequately compensated contractor for its indirect costs. See also Andrews and Peacock, *supra* note 429, at 278; Rishe, *supra* note 27, at 6-46; Petit and Victorino, *supra* note 377, at 5. To protect the Federal purse, the Government closely reviews termination settlements to ensure that the costs claimed are adequately supported. Cost proposals of \$25,000 or more are submitted to the appropriate audit agency for audit. See FAR 49.107(a).

444 See e.g., Okaw Indus., ASBCA 17863, 77-2 BCA 12793 at 62,233 (questioning inclusion of interest in G&A); Big Three Indus., ASBCA 16949, 74-1 BCA 10,483 at 49,599 (questioning aircraft expense in G&A); Cyro-Sonics, Inc., ASBCA 13219, 70-1 BCA 8313 at 38,643-49, (examining every major category of indirect cost); Nolan Bros., ENG BCA 2680, 67-1 BCA 6095 at 28,217 (questioning officer's salaries, depreciation, completed project expense, insurance).

445 See e.g., Cyro-Sonics, Inc., ASBCA 13219, 70-1 BCA 8313 at 38,653-54. The Government challenged inclusion of \$112 of organizational expense in an indirect cost pool of \$212,821. Note that FAR 49.107(a) requires that termination proposals of over \$25,000 be submitted to the appropriate audit agency for review.

446 See e.g., FAR 52.249-2, Termination for Convenience of the Government (Fixed-Price), Oct 74, paragraph (h). "The cost principles and procedures of Part 31 of the Federal Acquisition Regulations, in effect on the date of this contract, shall govern all costs claimed, agreed to, or determined under this clause."

447 See Rishe, *supra* note 27, at 6-45. Rishe cites *Codex Corp. v United States*, 226 Ct. Cl. 693 (1981) as authority for this position. The Court held that the Cost Principles alone are not the sole basis of determining allowability when a fixed price contract is terminated for convenience, that the Government must consider the fairness of strictly applying the Cost Principles. See also Alston, *supra* note 148, at 394; Joseph & O'Donnell, *supra* note 377, at X-7, Petit and Victorino, *supra* note 377, at 2.

448 *Id.*

449 For example, costs incurred before contract award are not, except in limited circumstances, allowable under the Cost Principles. See *Codex Corp.*, ASBCA 17983, 75-2 BCA 11554 at 55,154, *rev'd on other grounds*, 226 Ct. Cl. 693 (1981).

450 FAR 49.113 (emphasis added).

451 "A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract. . . . Fair compensation is a matter of judgment. . . . The use of business judgment, as distinguished from strict accounting principles is the heart of a settlement." FAR 49.201(a).

452 See *Codex Corp. v. United States*, 226 Ct. Cl. 693 (1981); *Fiesta Leasing and Sales*, ASBCA 29311, 87-1 BCA 19622 at 99,292; *Arctic Corner, Inc.* VABCA 2393, 86-3 BCA 19278 at 97,456-57; *Huskie Oil NPR Operations*, IBCA 1792, 86-1 BCA 18568; *H & H Reforestation*, AGBCA 84-311-3, 85-3 BCA 18,255 at 91,637; *Kalser Elec.*, DOTCAB 1425, 84-2 BCA 17343; *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295 at 86,162; *General Elec.*, ASBCA 24111, 82-1 BCA 15,725 at 77,803, *motion for reconsid. denied*, 82-2 BCA 16,207; *Marlin Assoc.*, GSBCA 5663, 82-1 BCA 15738 at 77,876; *American Elec.*, ASBCA 16635, 76-2 BCA 12151 at 58,512-13. But see *Allied Materials and Equip.*, ASBCA 17318, 75-1 BCA 11150 at 53,084 (Cost Principles were not "guide" but mandatory for Board); *Big Three Indus.*, ASBCA 16949, 74-1 BCA 10,483 at 49,593-94 (Cost Principles mandatory).

453 *Bedingfield and Rosen*, *supra* note 27, at 15-7, comment that the Cost Principles will be applied except in very limited circumstances. They credit changes in the Cost Principles and the increasing influence of DCAA for this result. See e.g., *Penberthy Electromelt Int'l v. United States*, 11 Cl. Ct. 307, 319 (1986). Court did not use the overhead rates which best reflected the average overhead costs of contractor. "[P]laintiff's concept of 'equity' flies squarely in the face of the principle of cost allocability." *Id.*

454 FAR 49.207.

455 *Id.*

456 A constructive change occurs when a contractor performs work beyond the contract requirements without a formal change

order and such work was informally ordered by the Government or caused by Government fault. See Cibinic & Nash, *supra* note 1, at 304-5.

457 A differing site condition exists when (1) subsurface or latent physical conditions at the site differ materially from those indicated in the contract or (2) unknown physical conditions, of an unusual nature, differing materially from those ordinarily encountered and generally recognized as inhering in work of the character provided for in the contract, are encountered. See FAR 52.236-2 and Cibinic & Nash, *supra* note 1, at Chapter 5.

458 Normally, it is the Government and not the contractor who is concerned that costs properly characterized as settlement costs are not claimed as performance costs. The reason is twofold. First, profit is allowed on costs of performance but not on settlement costs. Second, FAR 31.205-42(g) limits the indirect cost markup applied to settlement costs.

459 See FAR 49.207.

460 FAR 31.205-42(b).

461 See Systems Dev., ASBCA 16947, 73-1 BCA 9788; Nolan Bros., Eng. BCA 2680, 67-1 BCA 6095.

462 See Trustees of Columbia Univ., ASBCA 15578, 73-1 BCA 9777; Telecomputing Servs., ASBCA 10644, 68-1 BCA 7023.

463 Completion of work in progress is allowable when necessary to prevent a total loss of the items. See Development and Technical Assocs., IBA 150-8-81, 85-3 BCA 18314; Kinn Elecs., ASBCA 16440, 72-1 BCA 9299.

464 For example rental costs under unexpired leases. See Joseph & O'Donnell, *supra* note 377, at X-34, 35, and 46.

465 Mitigation costs include such as advertising to sell special equipment idled by the termination. See Fiesta Leasing & Sales, ASBCA 23911, 87-1 BCA 19622.

466 Post-termination unabsorbed overhead, unlike other continuing costs is normally not recoverable. Post-termination unabsorbed overhead is discussed at *infra* Chapter 4, Part V.

467 See *Rishe*, *supra* note 27 at 6-52; *Trueger*, *supra* note 27 at 757-58. But see *Detroit Diesel Allison Div., General Motors Corp.*, ASBCA 20199, 77-1 BCA 20199 at 60,115, (disallowing severance pay as a direct cost because the contractor's established accounting practice was to recover abnormal as well as normal separation costs through overhead).

468 But see *Systems Dev.*, ASBCA 16947, 73-1 BCA 9788 (allowing G&A on severance pay).

469 See FAR 49.104 and FAR 52.249, Termination for Convenience of the Government (Fixed-Price), paras. (b) through (d).

470 *Id.*

471 See FAR 49.207.

472 See FAR 52.249-4. See also *Maibens, Inc.*, ASBCA 25915, 82-1 BCA 12668 at 77,478-79; *Mrs. Landscaping and Nursery*, HUD BCA 76-29, 78-1 BCA 13077 at 63,860-61; *American Maint. and Mgt Servs.*, ASBCA 19556, 76-2 BCA 11,960 at 57,341; *Contract Maint.*, ASBCA 21186, 76-2 BCA 12,102 at 58,143. The short-form termination for convenience clause allows recovery for services rendered before the effective date of termination only. It is included in service contracts when it is anticipated that the only claim made would be for services rendered prior to termination if the contract were terminated for convenience. The boards have shown some willingness not to enforce the provisions of the clause when doing so would deny fair compensation to the contractor. See *Tefft, Kelly and Motley, Inc.*, GSBGA 6562, 83-1 BCA 16177 at 80,388.

473 FAR 49.202(a).

474 See D. ARVANAS AND W. RUBERRY, *GOVERNMENT CONTRACT GUIDEBOOK*, 16-15 (1st ed. 1986); *Bedingfield and Rosen*, *supra* note 27, at 15-27; *Joseph and O'Donnell*, *supra* note 377, at X-48 to 49; *Petit and Victorino*, *supra* note 377, at 8.

475 See FAR 31.205-42(g). Direct charging is one way to ensure full recovery of settlement costs. A settlement action usually does not generate sufficient direct costs of its own to compensate the contractor fully through application of the contractor's normal indirect cost rates to the direct costs generated. Inclusion of these indirect

costs in indirect cost groupings distributes a portion of such costs to the terminated contract through allocations to the pre-terminated work. However, such distribution is not proportional to the relative benefits received from the indirect cost grouping by the terminated contract. *But see* *Fiesta Leasing and Sales*, ASBCA 29311, 87-1 BCA 19622 at 99,292. In *Fiesta Leasing*, the Board disallowed, as a direct settlement cost, a salaried employee's time spent in preparation and presentation of the settlement proposal reasoning that no additional employees were hired to free him from performance of his normal duties--therefore, his salary was recoverable through G&A and not as a direct cost. The Board limited direct recovery to incremental costs only. See also *infra* note 489 and accompanying text where Bedingfield and Rosen suggest a one time special indirect cost allocation as an alternative to direct charging.

⁴⁷⁶See e.g., *Fiesta Leasing and Sales*, ASBCA 29311, 87-1 BCA 19622 at 99,295 (disallowing direct recovery of utility, computer and copy expense and of office rental and painting in the absence of proof that an adjustment to overhead was made to prevent double counting); *Bob Tucker and Assoc.*, LBCA 83-BCA-16, 86-2 BCA 18990 at 95,902 (disallowing accounting, supplies, and telephone services charged as direct costs because they may have been included in contractor's indirect cost rate; finding it reasonable for the contractor to produce documents evidencing their specific authorization as a direct cost and subsequent removal from the indirect cost grouping); *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295 at 86,167-68; *Marlin Assoc.*, GSBCA 5663, 82-1 BCA 15738 at 77,880 (labor costs of manager and president were included in overhead and therefore could not be charged directly as a mobilization cost); *Bermite Div. of Tasker Indus.*, ASBCA 18280, 77-1 BCA 12349, *aff'd on motion for reconsid.*, 77-2 BCA 12731 at 61,883 (disallowing employee salary expense that had been included in G&A). Boards have allowed direct recovery of costs included in an indirect cost grouping on occasions where such costs make up only a small and insignificant amount of the indirect cost grouping or where the factual pattern is such that duplicate recovery is not present. See *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295 at 86,167-68.

⁴⁷⁷In *Bermite Div. of Tasker Industries*, ASBCA 18280, 77-1 BCA 12349, *aff'd on motion for reconsid.*, 77-2 BCA 12731 at 61,883, the double recovery threat was stated as follows:

Expenses carried as an element of G&A are assumed to be recovered in the year they are incurred and recorded, absent persuasive evidence to the contrary, and this recovery is derived from the totality of the contractor's then on-going business. Expenses so recorded and presumably recovered cannot retrospectively be removed from the indirect expense pool. Such 'relief' can be done only prospectively, i.e. before the expenses are recorded or, more importantly, before they are allocated to and recovered from the on-going business. In a situation such as is present here, we are faced with recovery which has already taken place. Thus, we are not concerned with 'relieving the G&A pool' retrospectively but we are concerned with and faced with the fact that recovery as a direct settlement expense now would result in double recovery of these expenses.

478 See *infra* notes 490-97 and accompanying text.

479 See FAR 31.205-42(g)(iii).

480 *Id.*

481 See e.g., Contract Maint., ASBCA 20689, 77-1 BCA 12446 at 60,294 (disallowing post-termination G&A because many of the items appearing in G&A had been charged directly as termination costs); Big Three Indus., ASBCA 16949, 74-1 BCA 10483 at 49,606; Sunstrand Turbo, ASBCA 9112, 65-1 BCA 4653 at 22,227, *aff'd*, 182 Ct. Cl. 31 (1968) (to allow G&A on termination settlement expense recovered as a direct charge would be grant administrative expense on administrative expense). In *Big Three Industries*, the contractor's G&A rate of 183% was not applied to direct settlement labor because the Board found that the contractor had already recovered its G&A expenses through G&A charges to other work performed during the period--the Board did allow a markup on direct settlement labor for fringe benefits and support factor charges.

482 If the drafters of the FAR had believed that contractors would be unable to identify the costs incurred in settling a terminated contract, undoubtedly they would have adopted a different reimbursement approach. The FAR evidences the drafters' overriding concern that contractors be fairly compensated. See FAR 49.113.

483 The relationship of the settlement action to indirect cost groupings differs from that of other cost objectives. For example, a termination action usually benefits much more from the incurrence of attorney and accounting costs than do other cost objectives. Also it benefits less than other cost objectives from the incurrence of certain indirect costs. "[N]ormal factory burden cannot be applied to settlement expense direct labor. To do so would allocate depreciation on factory machinery to a nonproducing cost objective." Bedingfield and Rosen, *supra* note 27, at 15-26.

484 "Settlement expenses including the following, are generally allowable . . . (iii) Indirect costs related to salary and wages incurred as settlement expenses . . . ; normally, such indirect costs shall be limited to payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs." FAR 31.205-42(g)(iii) (emphasis added).

485 See *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295 at 86,166-68 (direct manufacturing labor was allocated normal indirect costs--labor of indirect employees was allocated only fringe benefits); *Essex Electro Eng'rs*, DOT CAB 1025, 81-1 BCA 14838 at 73,247, *aff'd on motion for reconsid.*, 81-1 BCA 73,251 (adding normal indirect burden to direct labor costs of assembling the residual inventory for storage); *Okaw Indus.*, ASBCA 17863, 77-2 BCA 12793, at 62,229 (normal overhead and G&A allowed on post-termination packaging); *Thiokol Chem.*, ASBCA 17544, 76-1 BCA 11731 at 55,933-39 (adding normal indirect burden to direct labor required to shut down activities, to conduct final audit, and to negotiate a settlement agreement); *Condec Corp.*, ASBCA 14324, 73-1 BCA 9808 at 45,844; *Varo, Inc.*, ASBCA 16606, 72-2 BCA 9720 at 45,396 (although not convinced the contractor was entitled to one-half its normal burden on settlement costs, the Board was hesitant to question the contracting officer's decision allowing it); *Boeing Co.*, ASBCA 12685, 69-2 BCA 7795 (allowing direct settlement labor to be burdened with an indirect cost rate developed specifically for special service work orders--only indirect costs related to special service work orders were included in the indirect cost grouping). In a number of cases the board has, without discussion, allowed recovery of indirect costs at the contractor's normal indirect cost rates. See e.g., *Penberthy Electromelt Int'l v. United States*, 11 Cl. Ct. 307, 327 (1986) (allowing G&A on time spent by settlement negotiator); *Agrinautics*, ASBCA 21512, 79-2 BCA 14149 at 69,648 (allowing manufacturing overhead and G&A); *Allied Materials* and

Equip., ASBCA 17318, 75-1 BCA 11150 at 53,084 (allowing indirect expense and G&A).

486 *Id.* See Okaw Indus., ASBCA 17863, 77-2 BCA 12793 at 62,229. "The nature of the work was such that we believed in order to adequately to compensate the appellant for the work performed it would be inappropriate not to allow the appellant's overhead and G&A in effect during the post-termination period."

487 See *supra* note 485-86.

488 See Bedingfield and Rosen, *supra* note 27, at 15-28.

489 *Id.*

490 See *supra* note 436-43 and accompanying text.

491 See Petit and Victorino, *supra* note 377, at 2. Failure of proof is a common cause of disallowance. See *Acme Process Equip. v. United States*, 171 Ct. Cl. 251, 313-14 (1965), (no breakdown or justification--allowing only 440 of the 1332 hours claimed); *Arctic Corner, Inc.*, VABCA 2393, 86-3 BCA 19278 at 97,459-60 (in the absence of probative documentation allowing \$1,356 of \$12,900 claimed); *Worsham Constr.*, ASBCA 25907, 85-2 BCA 18016 at 90,367 and 90,378 (in the absence of documentation allowing only 80 of 280 hours claimed in connection with post-termination settlement action; disallowing indirect costs related to salaries and wages incurred as settlement expenses because the contractor failed to put on evidence of such costs); *Racquette River Constr.*, ASBCA 82-1 BCA 15769 at 78,054 (no records--limiting recovery to what the Government had allowed); *Chesterfield Assoc.*, DOT CAB 1028, 80-2 BCA 14580 at 71,900 (no documentation, jury verdict allowed \$450--63 page settlement proposal); *Henry Spen & Co.*, ASBCA 20766, 77-2 BCA 12784 at 62,178-83 (lack of documentary foundation--allowing of hours claimed for: president 272 of 848 hours, vice-president 184 of 750 hours, sales engineer 40 of 302 hours, production engineer 64 of 345 hours, purchasing agent 160 of 1,014 hours, original contract administrator 150 of 656 hours, successor contract administrator 368 of 1,863 hours); *H & J Constr.*, ASBCA 18521, 76-1 BCA 11903 at 57,085 (unsupported claim--allowing \$1500 of \$35,607.64 claimed); *Bell and Howell Co.*, ASBCA 18464, 75-1 BCA 10993 at 52,348 (settlement costs unsupported--allowing \$250 of \$3,909 claimed); *Clary Corp.*, ASBCA 19274, 74-2 BCA 19247 (allowing \$231.70 of \$4,339 of costs claimed--no accounting records--proof consisted of

estimates); Francis Assoc., ASBCA 14100, 70-2 BCA 8493 at 39,477 (lack of records--allowing \$5,411 of the \$42,126.31 claimed); Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,895. But see Codex Corp., ASBCA 17983, 74-2 BCA 10827, at 51,499 (allowing all of \$2825 claimed--costs were supported by affidavits of persons concerned); Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,897-98 (allowing all time claimed in preparation of termination claim based on estimates).

492 See Alston, *supra* note 148, at 390. "Contractors must abandon their usual accounting methods for the allocation of indirect costs. They must directly identify all the cost elements concerned . . . to ensure that they will recover all the expenses incurred." See also Bedingfield and Rosen, *supra* note 27, at 15-26; Trueger, *supra* note 27, at 765-66.

493 See Petit and Victorino, *supra* note 377, at 5.

494 Note that FAR 31.205-42(g)(iii), in effect, mandates direct recovery of settlement costs. See *supra* notes 474-89 and accompanying text.

495 Normally, a contractor's accounting system is not set up to segregate and specifically identify indirect costs to any one cost objective. FAR 31.205-42(g)(2) requires establishment of a cost account or work order to separately identify and accumulate settlement costs when settlement expenses are expected to be significant.

496 Contractors should be prepared to negate the possibility of double charging. "Salaries of personnel preparing the termination claim may be unallowable as direct charges to the terminated contract, where they are included in the contractor's general and administrative expense pool and charged on a prorated basis to ongoing business, if the evidence is insufficient to negate possible double counting." Andrews and Peacock, *supra* note 429, at 288 (citing Bermite Div., Tasker Indus., ASBCA 18280, 77-1 BCA 12349).

497 Petit and Victorino, *supra* note 377, at 5, comment:

A difficult problem in recovering these indirect costs is identifying all the costs. Because the people who are usually involved in these activities (often including officers of the company) are frequently not accustomed to keeping accurate time records, the

accounting records supporting their efforts may be
spotty or nonexistent.

498 FAR 31.205-42(g).

499 Discussed at *supra* notes 489-97 and accompanying text.

500 The reasonableness of attorney's fees depends upon "the fee customarily charged in the locality for similar services. . . . the novelty and difficulty of the question involved, the skill required to perform the legal services properly, the amount involved, and the reputation and experience of the lawyer performing the services." *Cyro-Sonics, Inc.*, ASBCA 13219, 70-1 BCA 8313 at 38,658 (citing Rule 2-106 of the American Bar Association Code of Professional Ethics). See *Switlik Parachute Co.*, ASBCA 18024, 75-2 BCA 11433; *Ace Barber Shop*, ASBCA 17292, 73-2 BCA 10052; *American Packers, Inc.*, ASBCA 14275, 71-1 BCA 8846; *Douglas Corp.*, ASBCA 8566, 69-1 BCA 7578. Despite Government challenges, boards appear reluctant to find that the hourly fee charged by an attorney is excessive--probably because of the complexity of a termination settlement. In each of the above cited cases the Board found the fees reasonable. But see *Tagarelli Bros. Constr.*, ASBCA 34793, 88-1 BCA 20363 at 102,990 (finding attorneys fees of \$125 per hour unreasonable and allowing \$75 per hour). Reasonable compensation for work performed by an in-house attorney is at the attorney's normal salary rate rather than the value of the services performed. See *Fil-Coil Co.*, ASBCA 23137, 79-1 BCA 13618; *Rockwell Steel Co.*, ASBCA 5034, 79-1 BCA 13845.

501 The boards of contract appeals have been hesitant to find the use of experts unreasonable--even when the amount of the termination settlement is small. Contractors unfamiliar with terminations for convenience who do not obtain expert advice risk not obtaining full compensation for their costs in that these actions are complex and require significant expertise.

502 The boards of contract appeals have on several occasions determined that the number of hours spent in preparation of a termination settlement by the contractor's executive and clerical personnel was unreasonable. See e.g., *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295 at 86,166; *Kleinschmidt Div.*, SCM Corp., ASBCA 22809, 78-2 BCA 13363 at 65,316; *Contract Maint.*, ASBCA 20689, 77-1 BCA 12446 at 60,293; *Clary Corp.*, ASBCA 19274, 74-2 BCA 19247 at 52,102. After deciding that the hours claimed are unreasonable, the boards' by jury verdict determine a reasonable number of hours. It

appears probable that the decisions are influenced, at least in part, by disbelief that the contractor spent the number of hours claimed preparing its settlement proposal. See e.g., *Celesco Indus.*, ASBCA 22460, 84-2 BCA 17295, at 86,166 (finding a lack of supporting documentation or testimonial evidence); *Clary Corp.*, ASBCA 19274, 74-2 BCA 19247, at 52,102 (finding the claim unsupported); *Bailfield Indus.*, ASBCA 20006, 76-2 BCA 12096 (finding the number of hours high but not excessive--good records).

503 The boards of contract appeals find it unreasonable to have professional or executive personnel perform clerical work and limit reimbursement accordingly.

504 See *Celesco Indus.*, ASBCA 22640, 84-2 BCA 17295 at 86,165.

505 See FAR 31.205-34(d): "Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with . . . the prosecution of claims or appeals against the Government . . . are unallowable" The proscription is not limited to outside services but includes any cost incurred in prosecuting a claim against the Government including management and clerical costs. See e.g., *American Elec.*, ASBCA 16635, 76-2 BCA 12151, at 58,501-02; *Bailfield Indus.*, ASBCA 20006, 76-2 BCA 12096 at 58,103; *Lieb Bros.*, ASBCA 10007, 74-1 BCA 10509; *Frigitemp Corp.*, VABCA 646, 68-1 BCA 6766; *Q.V.S., Inc.*, ASBCA 7513, 1963 BCA 3699.

506 "When allowable and unallowable claimed costs are commingled and there is not sufficient proof to segregate the allowable from the unallowable, the entire claim must be rejected." Paul E. McCollum, Sr., ASBCA 23,269, 81-2 BCA 15311 at 75,824, *aff'd*, 6 Ct.Cl. 373, 380 (1985).

507 "[I]t is the responsibility of an appellant seeking to recover legal expenses allegedly incurred in the settlement of a terminated contract to separate legal fees into proper categories or show some reasonable basis for separating settlement charges from charges for other work." *Henry Spen & Co.*, ASBCA 20766, 77-2 BCA 12784 at 62,187. See *Nolan Bros. v. United States*, 194 Ct. Cl. 1, 36-37, 437 F.2d 1371 (1971); *H & H Reforestation*, AGBCA 84-311-3, 85-3 BCA 18,255 at 91,640 (disallowing \$750 consultant fee because it was unclear whether or not the fee was incurred in litigation of a claim against the Government); *Robert M. Tobin*, HUD BCA 79-388-C20, 84-3 BCA 17,651 at 87,971 (denying all settlement preparation costs because contractor failed to explain the

nature and purpose of costs claimed); A-American, Inc., ASBCA 28823, 84-2 BCA 17479 at 87,088 (allowing only \$500 of \$8000 in legal fees claimed because the Board was unable with reasonable assurance to determine the amount of effort expended by the legal firm in settlement of the termination claim); R.G. Robbins & Co., ASBCA 27516, 83-1 BCA 27516 at 81,693; Contract Maint., ASBCA 20689, 77-1 BCA 12446 at 60,294; Cyro-Sonics, Inc., ASBCA 13219, 70-1 BCA 8313 at 38,658 (in the absence of an explanation as to why they were incurred accounting fees were considered as incurred in the prosecution of a claim against the Government); Western States Painting, ASBCA 13843, 69-1 BCA 7616 at 35,375 (denying recovery of all legal fees for failure to properly segregate the legal costs of preparing and presenting the settlement proposal to the contracting officer from those of making a claim against the Government); Algonac Mfg., ASBCA 10534, 66-2 BCA 5731 at 26,729 (allowing only \$10,000 of \$275,000 claimed for legal, accounting, and clerical expenses--not shown to relate to preparation or negotiation of the settlement agreement).

⁵⁰⁸See *Bailfield Indus.*, ASBCA 20006, 76-2 BCA 12096.

Inherent in virtually every settlement effort involving a complex Government contract claim is research into the facts and applicable law performed by one or both parties, which research would prove useful in the event of litigation. One might question the magnitude of legal expenses exceeding \$22,000 for a settlement effort alone. However, the Government does not contend that these particular expenses were unreasonably high.

Id. at 58,104. See e.g., *Kalvar Corp. v. Unites States*, 211 Ct.Cl. 192, 205-06, 543 F.2d. 1298 (1976); *E. A. Cowen Constr.*, ASBCA 10669, 66-1 BCA 6060 at 28,012, *modified on other grounds*, 67-1 BCA 6273; *Sunstrand Turbo*, ASBCA 9112, 65-1 BCA 4653 at 22,229. Compare *Racquette River Constr.*, ASBCA 82-1 BCA 15769 at 78,052; *Frigitemp Corp.*, VACAB 646, 68-1 BCA 6766 at 31,296-98.

⁵⁰⁹See e.g., *Dunbar Kapple, Inc.*, ASBCA 3631, 57-2 BCA 1448 at 4,895. See also *supra* notes 474-89 and accompanying text.

⁵¹⁰See FAR 31.205-42(g)(iii). But see *Sunstrand Turbo*, ASBCA 9112, 65-1 BCA 4653 at 22,226-28, *aff'd*, 182 Ct.Cl. 31, 57-60 (1968). Here, parties agreed that the direct costs of settling the subcontract did not cover home office expenses

and that the home office had substantially contributed to the subcontract settlement. The parties agreed to apply a 5% rate for G&A to the settlement amount of the subcontracts to compensate the contractor for this home office effort. The 5% rate was substantially less than the contractor's normal G&A rate.

⁵¹¹Essex Electro Eng'rs, DOT CAB 1025, 81-1 BCA 14838 at 73,247, *aff'd on motion for reconsid.*, 81-1 BCA 15109.

⁵¹²FPR 1-8.505-2 specifically stated, "Contractors shall not include in their settlement proposals the cost of property returned to suppliers. . . . Contractor's may include in their settlement proposals as 'other costs' the transportation, handling, and restocking charges with respect to the property so returned." Current regulations, while not as specific would also prohibit adding an indirect charge to property returned to vendors. Under FAR 31.205-42(g)(1), a contractor is normally required to charge such costs directly. See *supra* notes 474-89 and accompanying text.

⁵¹³Essex Electro Eng'rs, DOT CAB 1025, 81-1 BCA 14838 at 73,247, *aff'd on motion for reconsid.*, 81-1 BCA 15109.

⁵¹⁴See Sun Elec., ASBCA 13031, 70-2 BCA 8371 at 38,925.

The ordering for material purchases, in the first place, represents only a beginning of company operations for which, upon the whole, costs are covered under the burden and G&A expense; and, without some particular showing, routine cancellation could not be supposed as adding expense sufficient or so substantial as to bring all costs incurred in respect of appellant's partial cancellation into any approximation with the whole distributive cost share (\$5,16.71), which amounts to very nearly one-third the direct cost.

⁵¹⁵The indirect costs are unabsorbed because the contractor's distribution base has been reduced as a result of the termination.

⁵¹⁶See Chamberlain Mfg., ASBCA 16877, 73-2 BCA 10139.

The measure of recovery for the exclusive remedy afforded by the termination for convenience clause is costs incurred plus a reasonable profit on the work performed. . . . The claimed post-termination overhead

costs were neither incurred as a result of the work performed on the contract nor generated directly by the termination action. The termination action merely reduced the direct labor base against which appellant's overhead could be applied. In essence, appellant's plea is that fairness and equity require the Government to reimburse a terminated contractor who has been unable to recover its overhead by the acquisition of sufficient new business to generate enough labor to compensate for the labor lost because of the termination. However its arguments and analogies are not persuasive.

Just as anticipatory profits are not allowable, so a loss of business, whether in the guise of post-termination G&A or otherwise is not recoverable in a termination claim.

Id. at 47,678. See also *Nolan Bros. v. United States*, 194 Ct.Cl. 1, at 34-35, 437 F.2d 1371(1971); *Arctic Corner, Inc.*, VABCA 2393, 86-3 BCA 19278 at 97,458; *Celeasco Indus.*, ASBCA 22640, 84-2 BCA 17295 at 86,164; *Hewitt Contracting, ENG BCA 4596*, 83-2 BCA 16816 at 83,653; *Metadure Corp.*, ASBCA 21183, 83-1 BCA 16208 at 80,535-36; *General Elec.*, ASBCA 24111, 82-1 BCA 15725 at 77,803, *motion for reconsid. denied*, 82-2 BCA 16207; *Pioneer Recovery Sys.*, ASBCA 24658, 81-1 BCA 15059; *A.C.E.S., Inc.*, ASBCA 21417, 79-1 BCA 13809 at 67,725; *KDI Precision Prods.*, ASBCA 21522, 79-1 BCA 13640, at 66,899-00; *Systems & Computer Information*, ASBCA 18458, 78-1 BCA 12946 at 63,139; *Henry Spen & Co.*, ASBCA 20766, 77-2 BCA 12784 at 62,183; *Allied Materials and Equip.*, ASBCA 17318, 75-1 BCA 11150 at 53,093; *Technology Inc.*, ASBCA 14083, 71-2 BCA 8956 at 41,625, *motion for reconsid. denied*, 72-1 BCA 9281. Compare *Racquette River Constr.*, ASBCA 82-1 BCA 15769 at 78,051 (allowing unabsorbed overhead during four-month period between work stoppage and termination--unabsorbed overhead ceased at termination).

⁵¹⁷Joseph and O'Donnell, *supra* note 377, at X-36 to X-41; Trueger, *supra* note 27, at 745-760. Bedingfield and Rosen, *supra* note 27, at 15-16 to 15-20 also present arguments supporting allowability but do not argue as strongly for the proposition as do other commentators.

⁵¹⁸Joseph and O'Donnell, *supra* note 377, at X-36.

⁵¹⁹Joseph and O'Donnell misstate the regulatory objective. FAR 49.201(a) reads "A settlement should compensate the

contractor fairly for the work done and the preparations made for the terminated portions of the contract including a reasonable allowance for profit. . . ." (emphasis added). Unabsorbed overhead, like anticipatory profits, represents an opportunity cost and is neither work done nor preparations made for the terminated portion of the contract.

520 Joseph and O'Donnell quote UCC Section 2-708(2) for this proposition:

If the [difference between the market price and contract] is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages . . . due allowance for costs reasonably incurred and due credit for payments or proceeds of resale. (emphasis added).

521 See Trueger, *supra* note 27, at 745-60 and 805-06.

522 *Id.* at 756. He therefore argues that unabsorbed overhead should be recoverable for a reasonable period of time after termination.

523 "[Unabsorbed overhead] bear[s] an obvious and precise causal relationship to the government's action in terminating the contract for its convenience. From a cost accounting viewpoint, there is no basis to charge such costs to any cost objective other than the terminated contract." *Id.* at 760. Trueger's observation is incorrect. These indirect costs were not caused by the terminated contract nor does the terminated contract exclusively benefit from their incurrence. Such costs should be distributed equally among all the cost objectives of the base period in which the costs were incurred.

524 One unusual circumstance, warranting recovery of unabsorbed overhead after contract termination, exists when a contractor is forced out of business by an erroneous default termination. In *Southland Manufacturing Corp.*, ASBCA 16830, 75-1 BCA 10994 at 52,360-1, unabsorbed overhead was allowed from the effective date of termination, Dec. 22, 1964 until Jul. 1, 1965. The Board considered this a reasonable period for the contractor to finish work in process and wind up its business and disallowed the contractor's requests for unabsorbed overhead for a longer time period.

525 The regulatory objective of fair compensation may not be as broad as Joseph and O'Donnell assert. FAR 49.201(a) reads "A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract. . . ." (emphasis added). The regulations do not state as a goal nor define fair compensation in terms of putting the contractor in the same position it would have been in had the contract not been terminated. Recovery of anticipatory profits would be necessary to put the contractor back in the position it would have been in but for the termination. Nonetheless, the regulations expressly prohibit anticipatory profits. See FAR 49.202(a).

526 See *supra* note 516.

527 See *Metadure Corp.*, ASBCA 21183, 83-1 BCA 16208 at 80,536.

528 *Pioneer Recovery Systems, Inc.*, ASBCA 24658, 81-1 BCA 15059 at 74,493, described the loss as follows:

The termination of the subject contract, along with the inability of having additional work that could be immediately substituted . . . caused Pioneer's actual overhead rate for 1979 to increase and those contracts whose prices were determined based on those overhead forecasts experienced a loss of profitability.

529 *Id.* at 74,494, where the Board recognizing the potential effect a termination can have reasoned:

[A] contractor must decide for itself whether its negotiated prices and business forecasts warrant accepting the risk of such contingencies; and, in doing so, will necessarily have to consider the fact that the potential contract, to the extent not terminated, will absorb some overhead with which its other business would otherwise be burdened. Although convenience terminations are relatively rare, the risk of unabsorbed overhead in termination cases is essentially no different than in cases of a contractor's failure to obtain other business which it anticipates obtaining during the accounting period.

530Or as Paul Trueger would put it for a "reasonable" period of time after contract termination. See *supra* note 27, at 756.

531See Note, *Home Office Overhead for Construction Delays*, 17 Ga. L. Rev. 761, 765 at note 15 (1983). Research conducted by the author of the Note discloses that when computing lost profits most state courts characterize fixed overhead as a deductible cost of performance and, therefore, have not allowed its recovery.

532*Id.* at 764-68. Unabsorbed overhead is convincingly analogized to lost profits. At footnote 15, the author cites *Vitex Manufacturing Corp. v. Caribtex Corp.*, 377 F.2d 795,798 (3 Cir. 1967): "Although there is authority to the contrary, we feel the better view, is that normally, in a claim for lost profits, overhead should be treated as a part of gross profits and recoverable as damages, and should not be considered as part of the seller's costs." The Uniform Commercial Code also defines lost profit to include unabsorbed fixed overhead. See UCC 2-708(2), quoted at *supra* note 520. Thus, arguably unabsorbed overhead after contract termination is unallowable as anticipatory profit.

533See *Metadure Corp.*, ASBCA 21183, 83-1 BCA 16208 at 80,536.

534See Trueger, *supra* note 27 at 757-58. See also Rishe, *supra* note 27, at 6-52. "[A]lthough the costs of unabsorbed overhead . . . normally are unallowable in a termination settlement, normal cost components of unabsorbed overhead may be recoverable if separately identified and proven to be continuing costs of the termination. *Id.* (citing *Chamberlain Mfg.*, ASBCA 16877, 73-2 BCA 10139 and *Technology, Inc.*, ASBCA 14083, 71-2 BCA 8956).

535Trueger, *supra* note 27, at 758.

536See *Andrews and Peacock*, *supra* note 429, at 288; Rishe, *supra* note 27, at 6-64.

537It is sometimes difficult to determine the amount of the original contract price applicable to the terminated contract. See *Ideker, Inc.*, ENG BCA 4389, 87-3 BCA 20145 at 101,982-84. For purposes of illustration assume that one of several separately priced line items is terminated. Reducing the contract price by the unit price of the terminated line item may not be appropriate if the line items are not of

average profitability. For example, assume an item costing \$1000 direct labor and \$250 in indirect costs were deleted from the contract under a partial termination for convenience. Reduction of the contract price by item's unit price of \$1000 is improper. The contract price should be reduced by \$1250 plus reasonable profit (assuming the contract as a whole is profitable). Further, in some instances, the work terminated will be part of a lump sum bid. To determine the amount by which the contract price should be reduced the parties may have to estimate the direct costs of performing the terminated work, the indirect cost markup and reasonable profit on the terminated work.

538 See Alston, *supra* note 148, at 389; Andrews and Peacock, *supra* note 429, at 294; Bedingfield and Rosen, *supra* note 27, at 15-20.

539 See e.g., Marlin Assoc., GSBGA 5663, 82-1 BCA 15738 at 77,873.

540 FAR 49.104(d) and FAR 52.249-2(k).

541 See Varo, Inc., ASBCA 16606, 72-2 BCA 9720 at 45,393; Continental Elec, Mfg., ASBCA 14749, 71-1 BCA 9108 at 42,206.

542 See Seirracin/Sylmar, ASBCA 27531, 85-1 BCA 17875 at 89,551-52; Capital Elec., GSBGA 5300, 81-2 BCA 15281 at 75,679-80; Celesco Indus., ASBCA 21928, 81-2 BCA 15260; Varo, Inc., ASBCA 16606, 72-2 BCA 9720 at 45,396; Continental Elec., Mfg., ASBCA 14749, 71-1 BCA 9108 at 42,208; International Aircraft Servs., 65-1 BCA 4793.

543 See Varo, Inc., ASBCA 16606, 72-2 BCA 9720 at 45,394-95 (finding that nonrecurring tooling costs of \$10,503 were absorbed by 135 units rather than the 200 units called for in the original contract).

544 See e.g., Celesco Indus., ASBCA 22640, 84-2 BCA 17295 at 86,164; Askenazy Constr., HUD BCA 78-2, 78-2 BCA 13402 at 65,526; Henry Spen & Co., ASBCA 20766, 77-2 BCA 12784 at 62,178-83; American Maint. and Mgt Servs., ASBCA 18348, 74-2 BCA 18348; Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,883-84.

545 Computation and use of learning curves are discussed in the Armed Services Pricing Manual, *supra* note 24, at 3-28 to 3-29.

546 See e.g., Seirracin/Sylmar, ASBCA 27531, 85-1 BCA 17875 at 89,552 (adding both manufacturing burden and G&A); Capital Elec., GSBGA 5300, 81-2 BCA 15281 at 75,679-80; Bermite Div. of Tasker Indus., ASBCA 18280, 77-1 BCA 12349 at 59,762, *aff'd on motion for reconsid.*, 77-2 BCA 12731; Varo, Inc., ASBCA 16606, 72-2 BCA 9720 at 45,396.

547 See *supra* note 544.

548 See e.g., Robert M. Tobin, HUD BCA 79-388-C20, 84-3 BCA 17651 at 87,969-70 (holding that unabsorbed overhead was unrecoverable despite a large reduction in volume of work because the contractor failed to perform the unterminated work within the contractually specified completion date--the partial termination did not cause the decreased distribution base); R.G. Robbins & Co., ASBCA 27516, 83-1 BCA 27516, at 81,692-93 (disallowing unabsorbed overhead because evidence was lacking as to how the partial termination affected G&A); Chamberlain Mfg., ASBCA 14759, 71-1 BCA 8837 at 41,094 (disallowing unabsorbed overhead because no evidence was introduced as to the plant's activity or lack of activity on new business after termination).

549 *Id.*

550 See Dunbar Kapple Inc., ASBCA 3631, 57-2 BCA 1448 at 4,883-84. Variations of the above computation sometimes appear in board decisions. See e.g., Henry Spen & Co., ASBCA 20766, 77-2 BCA 12784 at 62,180-81. Also other approaches are sometimes used. For example, in *Marlin Associates*, GSBGA 5663, 82-1 BCA 15,738 at 77,874, the parties agreed to a 15% loss-of-volume surcharge applied to the direct costs of the completed portion of the contract.

551 See FAR 49.208 allowing the contractor an equitable adjustment for its increased costs of performing the unterminated portion of the contract.

552 Celesco Indus., ASBCA 22640, 84-2 BCA 17295 at 86,164 (citing Fairchild Stratos Corp., ASBCA 9169, 67-1 BCA 6225, *aff'd on motion for reconsid.*, 68-1 BCA 7053).

553 The 212% indirect cost rate used for contract pricing was substantially higher than the actual indirect cost rate. Thus, either more work was performed during the period than anticipated despite the partial termination or fewer indirect

costs were incurred than anticipated, or both. The Board's rationale for finding that the contractor suffered no loss is that the contractor prepared its bid using a cost rate that was higher than it actually experienced. Had the contractor known in advance what its actual indirect cost rate would be the contract price would have been lower, not higher.

554 The amount of an equitable adjustment is based on "the difference between what it reasonably would have cost to perform the work as originally required and what it reasonably cost to perform the work as changed" not on what the parties would have agreed to at the time of contracting had they known what actual costs would be. See *supra* note 13 and accompanying text.

555 Wheeler Bros., ASBCA 20465, 79-1 BCA 20465.

556 *Id.* at 66,919.

557 A 40% increase in the sales volume of almost any business is going to substantially increase indirect costs. More administrative, clerical, and warehousing time are needed to process additional sales. Similarly more paper, machine time and clerical supplies are needed. The effect of increased volume on cost is discussed at *supra* notes 108-16 and accompanying text.

Note 558 begins on page 264.

558 Equitable adjustments and terminations for convenience are both priced on a cost basis as are cost reimbursement and cost plus fixed fee contracts.

559 "Perhaps the most important principle of accounting is consistency." Bruce Constr., ASBCA 5932, 60-2 BCA 2797, at 14,388 (citations omitted). See also Rishe, *supra* note 27, at 13-2.

560 See *supra* notes 146-150 and accompanying text.

561 It is a "generally accepted accounting principle that accounting practices, once adopted, be adhered to over time. As such, any accounting changes must be justified by the circumstances, and only when they will reflect more accurately the actual costs of the contractor." Rishe, *supra* note 27, at 13-6. See also Scientific Am. Corp., IBCA 576-666, 67-2 BCA 6670 at 30,957.

562 The contracting officer is required to incorporate by reference the Cost Principles in contracts with commercial organizations as a basis for proposing, negotiating, or determining costs under terminated contracts, and for pricing changes and other contract modifications. FAR 31.103(b)(3), and (6).

563 FAR 31.201-2(a)(3).

564 See FAR 31.202(a) and 31.203(a). See also Bethlehem Steel Co., ASBCA 9263, 65-1 BCA 4676 at 22,339.

565 FAR 31.202(a). What constitutes a "cost incurred for the same purpose in like circumstances" is discussed *infra* notes 598-622 and accompanying text.

566 FAR 31.203(a).

567 Denial of recovery is in essence a forfeiture and boards and courts seldom enforce forfeitures. The most likely result is that recovery would be allowed but in the manner least favorable to the contractor.

568 See *supra* Chapter 1, para. IV.B. If the contract is subject to the CAS, then any modification to the contract or termination of the contract is likewise subject to the CAS. Similarly if a contract is not subject to the CAS, any modification or termination of the contract is not subject to

the CAS, unless of course the modification independently meets the dollar thresholds of the CAS.

569A Disclosure Statement is not required of all contractors performing CAS-covered contracts. Only contractors receiving (1) a negotiated national defense contract or subcontract of \$10 million or more, or (2) net awards of negotiated national defense contracts and subcontracts totaling more than \$10 million in their most recent cost accounting period are required to submit Disclosure Statements. See FAR 30.202-1.

570FAR 30.401-40.

571FAR 30.401-50(a).

572Anderson, *supra* note 27, at 10-4, describes "actual cost" as follows:

The term "actual cost" suggests a degree of accuracy in a cost computation that would not be implied by the use of such terms as "appraised," "average," "estimated," or "standard." The implication of accuracy is misleading, however, because of the need for arbitrary assumptions and prorations in the determination of cost. It is nonetheless clear that actual cost has meaning only with respect to completed transactions and should not be used with respect to the future.

573FAR 30.401-20.

574" 'Reporting of costs' refers to (1) data presented in reports required by the contract such as budget and management reports for cost control purposes and (2) the data contained on public vouchers or any other request for payment." DCAA Audit Manual, 8-401.2a (1983).

575FAR 30.401-40(c). See also DCAA Audit Manual, 8-401.1b and c (1983).

576See Dayton T. Brown, Inc., ASBCA 22810, 80-2 BCA 14543 at 71,691 (holding that the contractor's request for bid and proposal costs on a basis different from that used in estimating such costs violated CAS 401).

577Id. at 71,692.

578Rishe, *supra* note 27, at 13-13.

579FAR 30.402-20.

580See FAR 30.402-20. See also *supra* notes 594-97 and accompanying text.

581FAR 30.402-40.

582FAR 30.402-50(b).

583FAR 30.402-50(c).

584FAR 30.402-50(d). Change is accomplished through the process of formally proposing a change in accounting practice and obtaining Government acceptance.

585See DCAA Audit Manual, 8-402b (1983).

586For example, without a consistency requirement a contractor could shift costs among cost pools or between accounting periods in order to increase its recovery of cost on Government contracts

587See Boeing Co., ASBCA 19224, 79-1 BCA 13708 at 67,248-49 (citing proposed but withdrawn CAS 417, Distinguishing between Direct and Indirect Costs).

588See e.g., Starks Contracting, VACAB 1339, 79-2 BCA 14018 at 68,848 (stating that costs not specifically identifiable with a contract cannot be charged to that contract as a direct cost).

589See Peter Kiewit Sons' Co., ENG BCA 4742, 85-1 BCA 17911 at 89,708; Foster Constr., DOT CAB 71-16, 73-1 BCA 9869. "It is rarely an easy task to determine whether a particular cost should be classified as direct cost or an indirect one. . . . Clearly, the procurement regulations provide no more than very broad, general definitions in differentiating between the two categories." *Id.* at 46,150.

590See Kleen-Rite Corp., GSBGA 5893, 83-2 BCA 16582. "Ultimately, 'direct' and 'indirect' are arbitrary categories, and the decision whether to call a given cost direct or indirect is to a great extent a matter of convenience." *Id.* at 82,467 (citation omitted).

⁵⁹¹See e.g., Peter Kiewit Sons' Co., ENG BCA 4742, 85-1 BCA 17911 at 89,708 (holding that the procurement regulations prefer "non-field labor be charged directly to a final cost objective whenever possible, but permit such labor to be treated as overhead, provided, in either case, that such treatment is consistently observed").

⁵⁹²Change in accounting practice is discussed *supra* Chapter 5, Part III.

⁵⁹³See FMC Corp., ASBCA 30130, 87-2 BCA 19791. Here a contractor attempted to include the costs of prosecuting a claim against another contractor in its G&A. The Board held that legal fees and other costs incurred prosecuting contract claims were direct costs of the contract from which they arose. Despite the contractor's established practice of including such costs in G&A the Board denied recovery stating:

To the extent [appellant's] CAS disclosure statements supported the indirect cost allocation of the claim expenses, they were inconsistent with the ASPR and CAS definitions of direct cost. ASPR 15-201.2 states that where disclosed practices are inconsistent with ASPR Section XV, Part 2, costs resulting from such inconsistent practices shall not be allowed in excess of the amount that would have resulted from the use of practices consistent with this Part 2.

Id. at 100,138. See also American Elec., ASBCA 15152, 73-1 BCA 9787 at 45,734 (regardless of contractor's general practice, the lease costs of a facility devoted exclusively to one contract were direct costs of that contract-- therefore, upon cancellation, the Government was entitled to a deductive credit in for the full direct cost savings).

⁵⁹⁴See e.g., Norris Indus., ASBCA 15442, 74-1 BCA 10482 at 49,561-62 and 49,578; Hurd-Darbee, Inc., ASBCA 12928, 68-2 BCA 7402 at 34,418. This type of overcharging occurs when indirect cost rates remain the same despite direct charging of a normally indirect cost (the direct charge is not removed from indirect cost groupings).

⁵⁹⁵Anderson, *supra* note 27, at 11-3, provides an example of this particular form of overcharging.

[A] contractor charges contract administration directly to contracts if a contract requires a full-time administrator. Contract administrators that handle more than one contract are charged to the G&A expense pool. Thus, the contract with a full-time administrator gets charged with its own contract administration plus a share of the contract administration performed for contracts that do not require a full-time administrator.

See also Volk Constr., IBCA 1419-1-81, 87-3 BCA 19,968 at 101,101 (characterizing as "serious overcharging" the claiming of supervisory costs as direct costs rather than overhead); McDonnell Douglas Corp., NASA BCA 873-10, 75-2 BCA 11568 at 53,993.

596 This form of overcharging is more difficult to detect than other forms of overcharging in that it requires detailed knowledge of what costs are included in a contractor's indirect cost grouping--knowledge often obtainable only by audit.

597 See Anderson, *supra* note 27, at 11-3.

598 The drafters of the FAR adopted the language of CAS 402 in establishing the Cost Principles' requirement for consistency. There are some minor differences in wording but the key language is the same.

599 FAR 30.402-40.

600 For example, when a contract is terminated for convenience, FAR 31.205-42 permits direct charging of initial costs and settlement expenses.

601 See FAR 30.402-60(a).

602 FAR 30.402-60(a)(1). Further, the contractor's Disclosure statement must be amended for the proposed change in accounting practices. *Id.*

603 "A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred." FAR 31.206(a).

604 FAR 30.402-60(a)(2).

605 *Id.* If the direct labor base inequitably distributes planning costs to the several cost objectives, the contractor should propose a change in its method of allocating such costs. The proposed change must be for all planning costs. The illustration suggests using the number of planning documents processed rather than direct labor as a allocation base.

606 See FAR 30.402-60(b).

607 FAR 30.402-61.

608 This language has been the subject of a recent ASBCA decision, *Boeing Co.*, ASBCA 29793, 88-1 BCA*** (decided Dec. 3, 1987). Boeing had been awarded a Phase I design contract specifically requiring it to submit a proposal for the Phase 2 production contract. Because it was Boeing's disclosed accounting practice to classify bid and proposal costs as direct costs if required by a specific contract task, bid and proposal costs for the Phase 2 contract were properly charged as direct costs. The question before the Board in *Boeing* was classification of proposal costs not specifically required by the Phase 1 contract but incurred by Boeing to enhance its chances of obtaining the follow-on contract--proposal costs incurred before the Government issued the detailed proposal instruction package and costs incurred after submission of the proposal in preparation of a best and final offer. The Board held that the Interpretation's rationale for permitting proposal preparation costs to be treated as direct costs applied with equal force to these costs. They were incurred for the same purpose and in like circumstances as the bid and proposal costs the contractor was specifically required to incur (both sets of proposal costs were incurred to obtain the follow-on contract). Therefore, the Board required that they be classified as a direct cost.

609 See e.g., *Hurd-Darbee, Inc.*, ASBCA 12928, 68-2 BCA 7402 at 34,418.

610 In many cases the contractor is trying to recover the same cost twice, directly and as part of an indirect charge. The duplication and inconsistency are obvious requiring little discussion. Even when it is not the same cost that is being claimed twice, the consistency issue is obvious in most circumstances. See e.g., *Volk Constr.*, IBCA 1419-1-81, 87-3 BCA 19,968 at 101,107 (reclassifying supervisory salaries from a direct cost to an indirect cost); Webster-Martin,

Inc., IBCA 778-5-69, 70-1 BCA 8120 at 37,729 (removing travel expense and mobile and fixed laboratory expense from indirect costs because costs of the same nature were charged to the contract as direct costs); Stanley Aviation Corp., ASBCA 12292, 68-2 BCA 7081 at 32,780 (denying as a direct cost the travel costs of six individuals whose salaries were charged indirectly because the contractor's established accounting practice was to charge travel costs in the same way that the employee's salary was charged); Telecomputing Servs., ASBCA 10644, 68-1 BCA 7023 at 32,469-72 (denying employee moving expenses after job completion as a direct cost because the contractor's established practice was to charge such costs indirectly). *But see* Bethlehem Steel Co., ASBCA 9263, 65-1 BCA 4676, *aff'd on motion for reconsid.*, 65-2 BCA 5004 at 23,597 (finding that excess short term power expense and utility expense were similar enough to require like classification as indirect costs).

611 Problems arising during contract performance may require the full time of a person whose salary is normally charged indirectly.

612 For example, if problems arise requiring full-time supervisory effort but no additional direct labor hours and the contractor uses direct labor hours as its distribution base, the contractor will not recover any additional indirect cost as compensation for devoting a supervisor full time to the job.

613 *See e.g.*, J.M.T Machine Co., ASBCA 23928, 85-1 BCA 17280 at 89,183 (denying chief engineer's salary as a direct cost of a constructive change even though he devoted 416 hours of his time to finding a solution); L&H Constr., ASBCA 23620, 81-1 BCA 14823 at 73,160 (despite spending significantly more supervisory time on a Government contract than on its other seven jobs, contractor was not allowed to charge a portion of its president's time directly to the Government contract and the remainder as an indirect cost); Platt Mfg., ASBCA 25077, 81-1 BCA 14894 at 73,688 (denying as a direct charge to a change order the time spent by administrative personnel correcting errors in a Government data package); Optimal Data Corp., NASA BCA 976-8, 79-1 BCA 1362, at 66,828-29 and 66,837 (denying as a direct cost time spent by contractor's president administering the contract during completion and subsequent closure). *But see* Walter Motor Truck Co., ASBCA 8054, 66-1 BCA 5365 at 25,172 (allowing contractor to charge normally indirect accounting costs as a direct cost because problems arising during performance required accounting

services way out of proportion to contractor's normal accounting patterns).

614The various forms of overcharging are discussed *supra* notes 594-97 and accompanying text.

615Note that CAS 402 uses this same factual pattern to illustrate a "cost incurred for the same purpose." See FAR 30.402-60(a)(2). See also *supra* notes 603-604 and accompanying text. However, *Rishe*, *supra* note 27, at 11-7 and 11-10, comments that quantitative differences do constitute a sufficient change in circumstances to justify direct charging so long as similar costs are eliminated from the distribution base.

616For a discussion of accounting changes see *supra* notes 638-77 and accompanying text.

617CAS 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives, permits a "special allocation" from the G&A expense pool when a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense than would be reflected by the allocation of such expenses using a cost input base. See FAR 30.410-50(j). A special allocation is allowable only in exceptional circumstances. See *Boeing Co.*, ASBCA 19224, 79-1 BCA 13708 at 67,241-42. Many of the earlier cases state in dicta that deviation from a contractor's established accounting practices is allowable in exceptional circumstances. Note that in each of the cited cases exceptional circumstances were found not to exist. See e.g., *Telecomputing Servs.*, ASBCA 10644, 68-1 BCA 7023 at 32,472; *American Scientific Corp.*, IBCA 576-666, 67-2 BCA 6670 at 30,957 (permitting deviation if the usual practice causes inequitable results); *Reynolds Metals Co.*, ASBCA 7686, 1964 BCA 4312, *motion for reconsid. denied*, 1964 BCA 4477. "It might under some circumstances be proper to make exceptions to appellant's ordinary accounting methods in order to meet special circumstances and more accurately reflect the costs of performing a particular contract and we have frequently so held." *Id.* at 20,856.

618See *Kleen-Rite Corp.*, GSBGA 5893, 83-2 BCA 16582 at 82,464 (finding no inconsistency in directly charging time spent as project manager and indirectly charging time spent as an area supervisor); *Electronics Corp.*, ASBCA 4770, 61-2 BCA 3134 at 16,275 (ten supervisory, clerical, or administrative

personnel were removed for periods of time from administrative duties to direct labor functions; it was consistent to charge a portion of these salaries as a direct cost and the remainder indirectly).

619Airtech Servs., DOT CAB 68-19, 68-2 BCA 7209.

620Under the current procurement regulations, FPR 1-15.202(a) is now FAR 31.202(a).

621Airtech Servs., DOT CAB 68-19, 68-2 BCA 7209 at 33,905.

622See American Fed. Contractors, PSBCA 1354, 87-1 BCA 19595 at 99,119 (holding that to recover labor costs of supervisory employees directly, contractor must show that they performed other than normal supervisory duties and directed themselves exclusively to the work directed by the modification). See also Electronics Corp., ASBCA 4770, 61-2 BCA 3134. The Board reasoned that no inconsistency existed:

In none of these instances is there attempted to be charged direct any supervisory, administrative, clerical or other activity of an indirect nature. In every case it was as though the employee resigned his position and accepted employment as a direct laborer. The production supervisors picked up tools and joined the army of direct production workers.

Id. at 16,275. Accord Kleen-Rite Corp., GSBGA 5893, 83-2 BCA 16582 at 82,464; Kenmore Garment Co., ASBCA 14142, 71-1 BCA 8768 at 40,698-99; Airtech Servs., DOT CAB 68-19, 68-2 BCA 7209 at 33,905-06.

623For a discussion of indirect cost groupings see *supra* notes 74-88 and accompanying text. The larger the number of cost groupings the more precisely a contractor can allocate indirect costs to cost objectives. See *supra* notes 75-78 and accompanying text.

624Consistency is required under GAAP. See *supra* notes 560-61 and accompanying text.

625See *supra* notes 74-88 and accompanying text.

626See e.g., American Scientific Corp., IBCA 576-666, 67-2 BCA 6670 at 30,956 (not allowing contractor to segregate the manufacturing overhead and labor costs of its two facilities

because it had established an accounting practice that combined such costs).

627 Consistency is required under GAAP. See *supra* notes 560-61 and accompanying text. See also Kinn Elecs., DOTCAB 69-25, 70-1 BCA 8176 at 37,986 (contractor trying unsuccessfully to exclude unbilled engineering labor costs from its cost of sales base in variance with its established practice of including such unbilled costs).

628 See *Litton Sys. v. United States*, 449 F.2d 392, 397-98 (Cl.Ct. 1971) (holding that a contractor using a cost of sales distribution base must define a "sale" for fixed price and cost reimbursement contracts similarly and could not treat progress payments under fixed price contracts differently than billings under cost reimbursement contracts); *Frederick Burk Found.*, ASBCA 15728, 73-1 BCA 9959 at 46,738-39 (holding that a contractor could not selectively use a different distribution base for one of its several contracts--any change had to apply to all).

629 See e.g., *Celesco Indus.*, ASBCA 22402, 80-1 BCA 14271 at 70,298 (refusing to allow special treatment for discontinuing segment of contractor's business that no longer benefited from G&A to the same degree as did other cost objectives); *Wolf Research and Dev.*, ASBCA 10913, 68-2 BCA 7222 at 33,546-47 (disallowing a separate allocation base for one set of fixed price contracts that allegedly benefited less from G&A than other contracts--would have allowed a separate allocation base if contractor had proved its use was reasonable); *Bruce Constr.*, ASBCA 5932, 60-2 BCA 2797 at 14,389 (refusing to allow a special overhead allocation for a change order that required more G&A effort than was recoverable under the contractor's established method of recovering indirect costs).

630 *Id.*

631 Change in cost accounting practice is discussed *infra* notes 638-677.

632 See FAR 31.202(c). "Once an appropriate base for distributing indirect costs has been accepted it shall not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs." *Id.* See also *Celesco Indus.*, ASBCA 22402, 80-1 BCA 14271 at 70,299.

633 See FAR 31.202(c). For a discussion explaining that unallowable costs should not be excluded from the distribution base see *supra* notes 165-67. Although the FAR prohibits removal of unallowable costs from a distribution base, not all authorities agree that removal of such costs is necessarily an inconsistent accounting practice or results in Government contracts being burdened with costs properly attributable to the unallowable costs. See e.g., Martin Marietta Corp., ASBCA 14159, 71-1 BCA 8793 at 40,794-95.

634 Base periods are discussed *supra* notes 98-106 and accompanying text.

635 See Nash-Hammond, Inc., ASBCA 15563, 71-1 BCA 9166 at 42,529 (finding that the contractor properly used its fiscal year for its distribution base despite the fact that during the last six months of its fiscal year (1) no work was done on the Government contract and (2) production volume substantially declined); EMR-Aerospace Sciences, NASA BCA 269-2, 70-2 BCA 8381 (finding that it was a departure from established accounting practice for contractor to use a two year base for start-up costs); Electronics Corp., ASBCA 4770, 61-2 BCA 3134 at 16,287-89 (not permitting contractor to use the period of contract performance--1 Oct 1954 to 31 Aug 1956--as its base period because this period was inconsistent with contractor's normal accounting practice); Daystrom Instrument, ASBCA 3438 at 5772, *modified on other grounds*, 58-2 BCA 2050 (not permitting contractor to use the 45-month period of contract performance as its base period because, among other things, such use was inconsistent with its established accounting practices). But see Itek Corp., NASA 27, 1963 BCA 3967 at 19,641. Only the last eight months of contractor's fiscal year were used as the base period. Use of the entire year was considered inequitable because it was contractor's first year in business and the first four months in existence were not representative of its normal operations.

636 The propriety of using a base period shorter than one year is discussed *supra* note 103.

637 Base period selection for terminations settlements is discussed *supra* notes 373-75 and accompanying text. Surprisingly, the contractor's choice of the period of contract performance as a base period rather than its normal base period has not been challenged as an inconsistent accounting practice.

638 Change in product mix, organization, volume of business, among others factors may make a once equitable cost accounting practice inequitable. FAR 31.203(d) describes three sets of circumstances under which a contractor should examine its accounting practices including (1) substantial differences in the cost patterns of work under the contract as compared to the contractor's other work, (2) changes in the nature of the contractor's business, and (3) application of cost groupings developed for the contractor's primary location to off site locations. See also *Rishe supra* note 27, at 13-16 to 13-19.

639 Both requirements must be demonstrated. See *Celesco Indus.*, ASBCA 23165, 80-1 BCA 14455 at 71,246; *Celesco Indus.*, ASBCA 22402, 80-1 BCA 14271 at 70,297-98; *Optimal Data Corp.*, NASA BCA 976-8, 79-1 BCA 13624 at 66,834; *Unidex Sys.*, PSBCA 24, 75-2 BCA 11,549 at 55,108; *Frederick Burk Found.*, ASBCA 15728, 73-1 BCA 9959 at 44,738; *Plasmadyne Corp.*, ASBCA 7731, 1962 BCA 7731 at 17684; *Hardy Mfg.*, ASBCA 4201, 58-1 BCA 1789 at 6941. But see *McDonnell Douglas Corp.*, NASA BCA 873-10, 75-1 BCA 11337 at 53,995 and 54,000, *motion for reconsid. denied*, 75-2 BCA 11568. The Board refused to require a contractor to demonstrate that its established cost accounting practices produced inequitable results as a prerequisite to its making a change. The contractor had only to prove that the change produce equitable results. In contrast the Board would require the Government to demonstrate that the contractor's established cost accounting practices were inequitable as a prerequisite to imposing an accounting change upon the contractor.

640 In *Celesco Industries*, ASBCA 22402, 80-1 BCA 14271 at 70,298, the Board recognized that the contractor's established method of distributing G&A disproportionately allocated G&A to the discontinuing Marine Systems segment of the contractor's business yet denied the change because other segments of the contractor's business had borne a disproportionately large share G&A during the start up period for the Marine Systems segment.

641 See *General Dynamics Corp.*, ASBCA 7963, 1964 BCA 4133 at 20,162, stating that "the sole fact that it would favor the Government does not justify a change in the circumstances to which these procedures are applied" (citations omitted). See *Boeing Co.*, ASBCA 11866, 69-2 BCA 7898 at 36,752, stating that "ordinarily, a contractor cannot change accounting practices merely for the purpose of obtaining the greatest

reimbursement on the basis of events that have previously occurred" (citations omitted). See also General Dynamics Corp., ASBCA 22461, 78-2 BCA 13270 at 64,886; Federal Elec., ASBCA 11324, 67-2 BCA 6416 at 29,733; Borg-Warner Corp., ASBCA 9144, 1964 BCA 4507 at 21,630 (stating that the Government cannot require a change merely because it would produce a more favorable dollar result for the Government).

⁶⁴²See Unidex Sys., PSBCA 24, 75-2 BCA 11549 at 55,109; Industrial Research Assocs., CAB WB-5, 71-1 BCA 8680 at 40,319; Telecomputing Servs., ASBCA 10644, 68-1 BCA 7023 at 32,472; Reynolds Metals Co., 1964 BCA 4312 (not permitting a change in accounting practice that affected only 1 of 16 plants).

It is not permissible . . . to establish a company-wide system of accounting, including a company-wide item of cost, and then to revise this system with respect to a single plant or program in order to revise the allocation of cost so as to charge it to that plant or program, contrary to its established method.

Id. at 20,856. See also Daystrom Instrument Div. of Daystrom, ASBCA 3438, 58-2 BCA 2050 at 8629.

⁶⁴³For background information and a definition of full and modified CAS coverage see *supra* notes 28-32 and accompanying text.

⁶⁴⁴See FAR 52.230-3(a)(2) and FAR 52.230-5(a)(3)(i). FAR 30.302-1 defines a cost accounting practice as "any disclosed or established accounting method or technique which is used for allocation of cost to cost objectives, assignment of cost to cost accounting periods, or measurement of cost."

⁶⁴⁵Change to a cost accounting practice is defined at FAR 30.302-2. The "initial adoption of an accounting practice for the first time a cost is incurred or a function is created is not a change in cost accounting practice." FAR 30.302-2(a). Similarly, the "revision of a cost accounting practice for a cost which has previously been immaterial is not a change in cost accounting practice." FAR 30.302-2(b). Changes which meet the definition of a change to a cost accounting practice are illustrated at FAR 30.302-3.

⁶⁴⁶See FAR 30.401-50(b) and FAR 30.402-50(d).

647 Prospective versus retroactive application of changes to cost accounting practices is discussed generally and with respect to CAS-covered contracts *infra* notes 663-77 and accompanying text.

648 See FAR 30.401-50(b) and FAR 30.402-50(d).

649 See FAR 30.602-3.

650 See FAR 30.602-3(a).

651 See FAR 30.602-3(b). The cost impact proposal must be sufficiently detailed to allow evaluation and negotiation of the cost impact on each CAS-covered contract and subcontract.

652 See FAR 30.602-3(c).

653 See Anderson, *supra* note 27 at 4-17.

654 *Id.* If the contracting officer determines that the change is desirable and not detrimental to the Government, an equitable adjustment to contract price is negotiated under the Changes clause of the contract. See FAR 52.230-3(a)(4)(iii) and FAR 52.230-5(a)(3)(ii).

655 A downward equitable adjustment to a firm fixed-price contract is warranted if as a result of the change the contractor allocates less cost to a fixed-price contract than would have been allocated by use of its disclosed cost accounting practices on which the contract negotiation was based. See Anderson, *supra* note 27, at 4-23 for a discussion of downward equitable adjustments to firm fixed-price contracts.

656 See FAR 52.230-3(a)(5) and FAR 52.230-5(a)(4).

657 See FAR 30.602-2. See also Anderson, *supra* note 27, at 4-31.

658 *Id.*

659 See Boeing Co., ASBCA 11866, 69-2 BCA 7898.

Ordinarily, a contractor cannot change accounting practices merely for the purpose of obtaining the greatest reimbursement . . . Yet the [procurement

regulations] recognize, by implication the possibility of changes arising out of circumstances peculiar to the business of the contractor. In addition, the Board has also recognized the right of the contractor to change its accounting methods when it can show a valid basis therefor.

Id. at 36,752 (citations omitted). See also Salisbury & Dietz, Inc., IBCA 20107, 87-3 BCA 2090 at 101,814 (no absolute prohibition against change); AC Elecs. Div., General Motors Corp., ASBCA 14388, 72-2 BCA 9558 at 44,521; Federal Elec., ASBCA 11335, 67-2 BCA 6416, at 29733; Coleman Eng'g, ASBCA 9478, 65-1 BCA 4695 at 22,420 (no inflexible rule that a contractor must follow the same accounting practice, if to do so distorts the results of business operations).

⁶⁶⁰See e.g., Chrysler Corp., NASA BCA 107501, 77-1 BCA 12482 at 60,511; AC Elecs. Div., General Motors Corp., ASBCA 14388, 72-2 BCA 9558. However, the Government cannot require a change "merely because such a change would produce a more favorable dollar result for the Government." Borg-Warner Corp., ASBCA 9144, 1964 BCA 4507 at 21,630.

⁶⁶¹See Salisbury & Dietz, Inc., 87-3 IBCA 20107, 87-3 BCA 20107 at 101,814. See Rishe *supra* note 27. "Under the Cost Principles, there is no affirmative disclosure requirement, except in the case of accounting changes that warrant disclosure pursuant to generally accepted accounting principles. The Government's right to audit the contractor's books constitutes its chief means of supervision." *Id.* at 13-7.

⁶⁶²Failure to give advance notice of a change in accounting practice does not necessarily prevent the change from being given effect by a court or board but does increase the likelihood of Government challenge. See Salisbury & Dietz, Inc., 87-3 IBCA 20107, 87-3 BCA 20107. Here, the Government challenged an accounting change of which it had not been given notice even though, as the Board found, it was not prejudiced by the change. The Board gave effect to the change despite lack of notice to the Government:

[T]here is no absolute prohibition against a change . . . regardless of failure to notify and secure approval . . . in any event, existence of an unapproved change is not grounds for denying all costs, . . . tribunals should give consideration to

the equities of the situation and investigate whether giving effect to the change would result in the allowance of 'an item of cost to the prejudice of the other' party.

Id. at 101,814.

⁶⁶³The Cost Accounting Standards clause, FAR 52.230-3 is a mandatory clause for CAS-covered contracts. The limitation is set forth as follows: "If any change in cost accounting practice is made for the purposes of any contract or subcontract subject to CAS requirements, the change must be applied prospectively to this contract and the Disclosure Statement must be amended accordingly" (emphasis added). The Disclosure and Consistency of Cost Accounting Practices clause, FAR 52.230-5 is a mandatory clause for contracts subject to modified CAS coverage. Its limitation is set forth as follows: "After the terms and conditions under which such change is to be made have been agreed to, the change must be applied prospectively to this contract and the Disclosure Statement, if affected, must be amended accordingly" (emphasis added). Although these clauses have been mandatory since at least 1978 (See DAR 7-104.83(a)), they have not been used by courts or boards as a basis for denying retroactive application of changes in cost accounting practices. See e.g., Data-Design Laboratories, ASBCA 27245, 86-2 BCA 18830 (refusing to allow the Government to retroactively apply a change in cost accounting practice, discussing retroactive application from the viewpoint of the CAS, but not mentioning the prospective application language included in the Cost Accounting Standards clause of the contract).

⁶⁶⁴Under the Cost Principles, the terms of the contract are one of five factors considered in determining whether a cost is allowable. See FAR 31.201-2(a)(4). When a contractor's cost accounting practices are inconsistent with the terms of the contract, the costs resulting from such inconsistent practices are not allowable in excess of the amount that would have resulted from consistent practices. See FAR 31.201-2(c). Compare FMC Corp., ASBCA 30130, 87-2 BCA 19791 at 100,138 (denying costs in excess of the amount that would have resulted from the use of accounting practices consistent with the Cost Principles).

⁶⁶⁵See e.g., FMC Corp., ASBCA 30130, 87-2 BCA 19791 at 100,139.

666 For CAS-covered contracts, the requirement for prospective application is contained in the Cost Accounting Standards clause, FAR 52.230-3 and the Disclosure and Consistency of Cost Accounting Practices clause, FAR 52.230-5. There are no similar clauses that apply to non-CAS-covered contracts.

667 Celesco Indus., ASBCA 20569, 77-1 BCA 12445 at 60,287-88.

668 A mid-year change in effect reduces the base period into two shorter base periods. Use of base periods shorter than one year may yield cost allocation rates which do not accurately reflect the normal operations of a contractor's business. See *supra* notes 98-104 and accompanying text.

669 See Celesco Indus., ASBCA 23165, 80-1 BCA 14455 at 71,2467 (applying a more stringent test applied to mid-year accounting changes than to changes in accounting practices proposed to begin at the beginning of a year).

670 See Blue Cross and Blue Shield Ass'n, ASBCA 26529, 86-2 BCA 18,571 at 94,427; Celesco Indus., ASBCA 20569, 77-1 BCA 12445 at 60,287; Stanwick Corp., ASBCA 18083, 76-2 BCA 12,114 at 58,179; Unidex Systems, Inc., PSBCA 24, 75-2 BCA 11,549 at 55,109; Peninsular Chemresearch, Inc., ASBCA 14384, 71-2 BCA 9066 at 42,054-55; Reynolds Metals Co., ASBCA 7686, 1964 BCA 4312 at 20,856; Daystrom Instrument Div. of Daystrom, ASBCA 3438, 58-2 BCA 2050 at 8628-29.

671 Zero Mfg., ASBCA 14558, 70-2 BCA 8489 at 39,460 (emphasis added). See also Celesco Indus., ASBCA 20569, 77-1 BCA 12445 at 60,287.

672 See Blue Cross and Blue Shield Ass'n, ASBCA 26529, 86-2 BCA 18,571. The Board denied the contractor's claim that certain indirect costs should be allocated on a retroactive basis to the contractor's Government as well as commercial business. "Neither appellant or the Government (in the absence of some possible peculiar circumstance not present here) may retrospectively change the accounting treatment of an item of cost to the prejudice of the other. The commercial havoc which could otherwise ensue is obvious." *Id.* at 94,427 (citations omitted).

673 See e.g., *Litton Sys. v. United States*, 449 F.2d 392, 398-401 (Cl.Ct. 1971); *Data Design Laboratories*, 86-2 BCA 18830 at 94,889; *Falcon Research & Dev.*, ASBCA 19784, 77-1 BCA 12312 at 59,484; *AC Elecs. Div., General Motors Corp.*, ASBCA

14388, 72-2 BCA 9558 at 44,521-22; Martin Marietta Corp., ASBCA 14159, 71-1 BCA 8783 at 40,794; Zero Mfg., ASBCA 14558, 70-2 BCA 8489 at 39,460 (allowing a change to be given retroactive effect based in part on finding no evidence that the contractor's fixed price contracts would have been lower priced had the new practice been in effect at their inception).

674 Obviously, a contractor cannot reprice any of its commercial fixed-price contracts. Repricing of fixed-price Government contracts raises the question of whether the contractor would have received the contract in the first instance had its price been higher.

675 See e.g., *Litton Sys. v. United States*, 449 F.2d 392, 398-401 (1971); *Data Design Laboratories*, 86-2 BCA 18830, at 94,889; *Falcon Research & Dev.*, ASBCA 19784, 77-1 BCA 12312 at 59,484; *AC Elecs. Div., General Motors Corp.*, ASBCA 14388, 72-2 BCA 9558 at 44,521-22. Compare *Chrysler Corp.*, NASA BCA 107501, 77-1 BCA 12482 at 60,511. The Board retroactively changed the contractor's method of accumulating and allocating costs from a single pool to a multiple pool method. The contractor, in accordance with its established accounting practices, had charged all of an off-site facility's rental, occupancy, and other costs to the single burden pool. When the character of work at this off-site location changed from bid and proposal to commercial production type work, the contractor continued to charge such costs to the single pool for distribution to all the contractor's work even though such work was only marginally beneficial to Government contracts and specifically identifiable with a commercial venture. *Chrysler Corp.* can be distinguished from the other cases involving retroactive application of change in that the costs sought to be retroactively applied were specifically identifiable with commercial work. The contractor's ability or inability to reprice fixed-price contracts was not discussed.

676 The role of cost in the pricing of commercial and Government contracts is discussed at supra notes 23-24, and accompanying text. In the absence of competition, cost plays a dominant role in pricing Government contracts. Thus, forfeiture is a possibility to the extent that the contractor's business, during the period for which retroactive application is sought, included sole source Government contracts, modifications to fixed-price Government contracts, or terminations for convenience of Government contracts.

677The converse is true if the the contractor's fixed-price contracts were priced through negotiation and in reliance on cost or pricing data submitted by the contractor.

678See *supra* note 170 and accompanying text. Most contractors use a direct labor dollar distribution base, although other bases are used occasionally.

679See e.g., *Fidelity Constr.*, ENG BCA 4322, 83-2 BCA 16710 at 83,118 (denying manager's salary as a direct cost of the equitable adjustment); *Propserv Inc.*, ASBCA 23617, 81-2 BCA 15,182 at 75,138 (denying contractor's vice-president's salary as a direct cost of an equitable adjustment); *L&H Constr.*, ASBCA 23620, 81-1 BCA 14823 at 73,160 (denying contractor's president's salary as a direct cost despite his becoming a "full-time supervisor" on the job due to numerous Government changes and differing site conditions--contractor could not charge a portion of his time directly to Government modifications and the remainder indirectly); *Machinery Assocs.*, ASBCA 20039, 77-1 BCA 12503 at 60,617 (denying contractor's president's salary and its chief engineer's salary as direct costs of the equitable adjustment); *F.F. Slocomb Corp.*, ASBCA 20169, 76-2 BCA 12071 at 57,923 and 57,926 (denying as a direct cost the following expenses that contractor normally classified as indirect costs: travel, freight, and trucking); *A. Campo, Inc.*, ASBCA 14830, 72-1 BCA 9377 at 43,542 (denying as a direct charge to the delay claim the salary of an employee performing administrative and supervisory services whose salary was otherwise charged indirectly); *Keko Indus.*, ASBCA 12729, 71-1 BCA 8713 at 40,478 (finding that the contractor normally charged per diem and travel as G&A, these costs were not permitted to be charged directly to a constructive change); *Industrial Research Assocs.*, CAB WB-5, 71-1 BCA 8680 at 40,319 (disallowing contractor's reclassification of its principal officers' salaries from a direct to an indirect cost--motive for the reclassification was the instant claim); *P.M.W. Constr.*, ASBCA 11121, 66-2 BCA 5901 at 27,370 (disallowing nonspecific items termed "expendables" and "supervision" as direct costs).

680See *supra* notes 199 and 204 and cases cited therein.

681It is economically feasible to specifically identify costs to the several cost objectives only when the benefits flowing from the increased accuracy achieved in assignment of costs outweighs the expense of specific identification.

682 See *supra* note 597 and accompanying text.

683 *Id.*

684 See *supra* notes 604-05 and 611-17 and accompanying text.

685 See *Bruce Constr.*, ASBCA 5932, 60-2 BCA 2797 at 14,389. The contractor argued unsuccessfully for a special overhead allocation for a change order that required more G&A effort than was recoverable under the contractor's established method of recovering indirect costs. The Board reasoned that duplication would occur unless recovery of overhead was reduced on those change orders where less overhead was required than was recovered under the contractor's established accounting practices. The Board recognized that on some change orders more indirect cost effort will be expended than is recoverable under the contractor's established accounting practices and on others, less indirect cost effort will be incurred than is recoverable.

686 See *supra* notes 410-13 and accompanying text.

687 See *e.g.*, *J.M.T. Machine Co.*, ASBCA 23928, 85-1 BCA 17280 at 89,183 (disallowing chief engineer's salary as a direct cost of a constructive change even though he devoted 416 hours of his time to finding a solution); *Platt Mfg.*, ASBCA 25077, 81-1 BCA 14,894 at 73,688 (time spent by administrative personnel correcting errors in a Government data package could not be charged directly for purposes of an equitable adjustment); *L&H Constr.*, ASBCA 23620, 81-1 BCA 14823 at 73,160. Because of changes and differing site conditions, contractor's president spent significantly more supervisory time on a Government contract than on its other seven jobs. Nevertheless, contractor was not allowed to charge a portion of its president's time as a direct cost for purposes of an equitable adjustment because it had not removed other portions of the president's salary from overhead and charged them directly to the contractor's other jobs to the extent he spent time on them. Compare *Kenmore Garment Co.*, ASBCA 14142, 71-1 BCA 8768 at 40,698-99 (allowing as a direct charge to the equitable adjustment the time of a supervisor who devoted 30 hours per week for 15 weeks exclusively to non-supervisory duties). In *Kenmore Garment* the supervisor did not just devote more time to the contract, he exclusively performed direct cost functions. When the work performed is qualitatively different from work normally performed by the employee, direct charging of the

employees time is often permitted. See *supra* notes 614-18 and accompanying text.

688 See e.g., *Metro Eng'g*, AGBCA 77-121-4, 83-1 BCA 16143 at 80,187. Absent evidence by contractor as to its established method of distributing indirect costs, the Board used the distribution base recommended by the Government, "proportion of job income" (12% markup) rather than the distribution base recommended by the contractor, direct labor (25% markup).

689 See *supra* notes 191-98 and accompanying text.

690 See *supra* notes 192-93 and accompanying text.

691 See *supra* note 235 and accompanying text.

692 See *supra* notes 282-88 and accompanying text.

693 The change in circumstance is that the delay has made recovery of fixed indirect costs using the contractor's normal accounting practices inequitable. See *supra* note 639 and accompanying text.

694 Doing so results in over recovery of fixed indirect costs for the delay period. See *supra* notes 356-59 and accompanying text.

695 See *supra* notes 598-99 and accompanying text.

696 FAR 30.402-61.

697 See Preambles to Cost Accounting Standard 402, Preamble C, para. (1). Note that factors other than consistency may dictate whether or not bid and proposal costs can be charged directly to a particular cost objective. A specific Cost Principle has been established to govern allowability of bid and proposal costs. See FAR 31.205-18.

698 See Preambles to Cost Accounting Standard 402, Preamble C, para. (1). The preamble makes it clear that proposals submitted under contract provisions "such as the requirement in the Changes clause . . . are considered to specifically incurred under the interpretation." *Id.* (emphasis added).

699 See FAR 30.402-61.

700 See Moloney & Rubien Contr., ASBCA 22280, 78-1 BCA 13000 at 63,401.

701 A termination for convenience in effect turns a fixed-price contract into a cost reimbursement contract. See *supra* note 429 and accompanying text.

702 Consistency as it applies to assignment of costs to indirect costs groupings was discussed *supra* notes 623-26, and as it applies to distribution base *supra* notes 627-33.

703 Reclassification of costs for purposes of terminations for convenience is discussed at *supra* Chapter 4, Parts II.B and IV.A. Part II.B discusses reclassification as it applies to pre-termination costs; Part IV.A discusses reclassification as it applies to settlement costs. Classification of costs as direct or indirect, including overcharging caused by inconsistent classification, is discussed generally *supra* Chapter 5, Part II.A.

704 See *supra* notes 374-75 and accompanying text.

705 See *supra* notes 560-63, 634-37, and accompanying text.

706 See *supra* notes 638-42 and accompanying text.

707 *Id.*

708 Few events other than the contractor going out of business will make accumulation of indirect costs over the contractor's fiscal year inequitable.

709 See *supra* notes 99-105.

710 Likewise, allowing the Government to selectively chose either the contractor's fiscal year or the period of contract performance as the base period depending upon which yields the most favorable result to the Government is inequitable.

VA OVERHEAD LIMITATION CLAUSE

S8-7.650-21 Contract changes.

Clause 3, Changes and Clause 4, Differing Site Conditions, of General Provisions, SF 23A, are supplemented as follows:

(a)

(d) Allowances not to exceed 10 percent each for overhead and profit for the party performing the work will be based on the value of labor material, and use of construction equipment required to accomplish the change. As the value of the change increases, a declining scale will be used in negotiating the percentage of overhead and profit. Allowable percentages on changes will not exceed the following: 10 percent overhead and 10 percent profit on first \$20,000; 7 1/2 percent overhead and 7 1/2 percent profit on next \$30,000; 5 percent overhead and 5 percent profit on balance over \$50,000. Profit shall be computed by multiplying the profit percentage by the sum of the direct costs and computed overhead costs.

(e) The Prime Contractor's or upper-tier subcontractor's fee on work performed by lower-tier subcontractors will be based on the next increased cost to the Prime Contractor or upper-tier subcontractor, as applicable. Allowable fee on changes will not exceed the following: 10 percent fee on first \$20,000; 7 1/2 percent fee on next \$30,000; and 5 percent fee on balance over \$50,000.

(f) Not more than four percentages, none of which exceed the percentages shown above, will be allowed regardless of the number of tiers of subcontractors.

(g) Where the contractor or subcontractor's portion of a change involves credit items, such items must be deducted prior to adding overhead and profit for the party performing the work. Where a change involves credit items only, such items will be net, i.e., overhead, profit, and fee are excluded. The contractor's fee is limited to the net increase to contractor of subcontractor's portions cost computed in accordance herewith.

(h) Cost of Federal Old Age Benefit (Social Security) tax and of Workmen's Compensation and Public Liability insurance appertaining to changes are allowable. While no percentage will be allowed thereon for overhead or profit. Prime Contractor's fee will be allowed on such items in subcontractor's proposals.

(i) Overhead and Contractor's fee percentages shall be considered to include insurance other than mentioned herein, field and office supervisors and assistants, watchmen, use of small tools, incidental job burdens, and general home office expenses, and no separate allowance will be made therefor.

(j) Bond premium adjustment, consequent upon changes ordered, will be made as elsewhere specified at the time of final settlement under the contract and will not be included in the individual change.

[34 FR 15470, Oct. 4, 1969, as amended at 38 FR 5478, Mar. 1, 1973; 39 FR 13263, Apr. 12, 1974; 41 FR 48519, Nov. 4, 1976; 45 FR 15930, Mar. 12, 1980]

GSA OVERHEAD LIMITATION CLAUSE

552.243-71 Equitable Adjustments.

As prescribed in 543.205(b), insert the following clause in solicitations and contracts for (a) dismantling, demolition, or removal of improvements; and (b) construction, when a fixed-price contract is contemplated and the contract amount is expected to exceed the small purchase limitation:

Equitable Adjustments (April 1984)

(a) The provisions of the "Changes" clause prescribed by FAR 52.243-4 are supplemented as follows:

(1)

Overhead, Profit and Commission

(2) The allowable overhead shall be determined in accordance with the contract cost principles and procedures in Part 31 of the Federal Acquisition Regulation (48 CFR Part 31) in effect on the date of this contract. The percentages for profit and commission shall be negotiated and may vary according to the nature, extent and complexity of the work involved, but in no case shall exceed the following unless the contractor demonstrates entitlement to a higher percentage:

	<u>Overhead</u>	<u>Profit (percent)</u>	<u>Commission (percent)</u>
To contractor on work performed by other than his own forces		10	
To first tier subcontractor on work performed by his subcontractors		10	
To contractor and/or the subcontractors for that portion of the work performed with their respective forces	(1)		10

¹To be negotiated.

Not more than four percentages will be allowed regardless of the number of tier subcontractors. The Contractor shall not be allowed a commission on the commission received by a first tier subcontractor. Equitable adjustments for deleted work shall include credits for overhead, profit and commission. On proposals covering both increases and decreases in the amount of the contract, the application of overhead and profit shall be on the net change in direct costs for the Contractor or subcontractor performing the work.

(3)

(b) The provisions of the "Differing Site Conditions" clause prescribed by FAR 52.236-2, are supplemented as follows: The Contractor shall submit all claims for equitable adjustment in accordance with, and subject to the requirements and limitations set out in, paragraph (a) of this "Equitable Adjustments" clause.

(End of Clause)

APPENDIX TWO

FORMULAS FOR RECOVERY OF UNABSORBED OVERHEAD

1. Eichleay

$$\frac{\text{Contract billings}}{\text{Total billings for the actual contract period}} \times \text{Total overhead} = \text{Overhead allocable to the contract}$$

$$\frac{\text{Allocable overhead}}{\text{Actual days of contract performance}} = \text{Overhead allocable to the contract per day}$$

$$\text{Daily overhead} \times \text{Number of Days} = \text{Unabsorbed overhead}$$

2. Modified Eichleay

$$\frac{\text{Original contract price}}{\text{Total billings for original contract period} + \text{Contract billings for extended period}} \times \text{Fixed overhead for the original contract period} = \text{Fixed overhead allocable to contract}$$

$$\frac{\text{Fixed overhead allocable to contract}}{\text{Original days of performance}} = \text{Daily contract fixed overhead}$$

$$\text{Daily contract fixed overhead} \times \text{Days delay} = \text{Unabsorbed Overhead}$$

3. Allegheny

$$\text{Incurred overhead rate during actual period} - \text{Incurred overhead rate for projected performance period} = \text{Excess rate of overhead}$$

$$\text{Excess rate of overhead} \times \text{Contract base costs} = \text{Unabsorbed overhead}$$

4. A.C.E.S.

$$\frac{\text{Fixed overhead costs}}{\text{Total overhead}} = \text{Fixed overhead rate}$$

$$\text{Overhead cost per hour} \times \text{Fixed overhead rate} = \text{Fixed overhead cost per hour}$$

$$\text{Hours delay} \times \text{Fixed overhead rate} = \text{Unabsorbed overhead}$$

5. Carteret

$$\text{Incurred overhead rate during delay period} - \text{Normal overhead rate} = \text{Excess rate of overhead}$$

$$\text{Excess rate of overhead} \times \text{Total Base Costs} = \text{Unabsorbed overhead during delay period}$$

